WEEK 41

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Friday, 8 October 2021

How Will Banks Fare If Housing Market Cools?

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AUSTRALIA

How Will Banks Fare If Housing Market Cools?

Does the outlook for the banks hinge on whether tightening measures will be instigated to cool home buyer lending?

-Measures to rein in the housing market could be on the way by year end
-Initial action likely to be modest and probably involve limits to DTI and LTV lending
-Main upside for banks will be measures allowing for a re-pricing of mortgages

By Eva Brocklehurst

As soaring house prices in Australia put lending under scrutiny, are regulators now gently massaging expectations for tighter conditions as 2022 approaches? Several brokers suspect some measures could be contemplated to cool the market.

Any macro prudential measures are likely to put a damper on housing and Macquarie expects credit growth and, potentially, property prices will moderate as a result. If these measures are effective it would limit the potential upside risk to bank earnings from credit growth.

A statement from the Council of Financial Regulators (CFR) has also raised broker alert levels, with a warning that a period of credit growth that materially outpaces household income will add to the medium-term risks that face the economy.

Still, brokers agree regulators do not appear to be in a rush, and while APRA (Australian Prudential Regulatory Authority) plans to release a paper over the next couple of months, it does not appear major tightening is imminent.

Commonwealth Treasurer Josh Frydenberg has reinforced the CFR statement, commenting about the need to restrain borrowing, particularly the amount of high debt-to-income (DTI) lending.

While surprised by the Treasurer's comments, as he had been keen to ease lending standards after banks tightened previously, Jarden now believes this is **a clear signal of the tightening risk on the horizon**. The broker expects 2022 could arrive before regulators make a move, after assessing the impact of lockdowns and the uncertain economic recovery.

JPMorgan also suspects APRA could be in a tightening mood, perhaps looking to target investors rather than owner occupiers/first home buyers. Investor loan applications have been rising, albeit the share of home loan balances is below historical averages.

As a result of the acceleration in housing credit growth, Morgan Stanley expects macro prudential measures will be implemented by the end of the year. Moreover, as the broker notes, **Commonwealth Bank** ((CBA)) CEO Matt Comyn has said "we think it would be important to take a modest step sooner rather than later".

Housing credit, over the 12 months to August, was up 6.2%. Credit Suisse also points to an all-time high of $17.2bn in refinancing home loan commitments, 60% above a year ago. **Borrowers appear to be seeking the lowest rates and cashback offers are also being used to attract customers to switch banks.**

The broker notes, of the major banks, **Westpac Bank** ((WBC)) offers the highest cashback offer for refinancing among the major banks, at $3000 when customers switch their home loan. **Bank of Queensland** ((BOQ)) and **Suncorp** ((SUN)) are also offering similar cashback amounts.

What Sort Of Tightening, And When?

Morgan Stanley expects an announcement from APRA in December, with the most likely measures being a limit on high DTI and high loan-to-value (LTV) lending and/or changes to interest-rate floors and buffers.

The broker believes at least two of these tools could be used to meaningfully narrow the gap between household credit growth and income growth. The measures are expected to reduce housing loan growth to 5% during 2022.

Nevertheless, the broker concedes, given the 2014-17 experience, initial action could be modest. The broker calculates every 50 basis points increase in bank interest rate floors reduces borrowing capacity by -5%. If this was applied to all new loan approvals this could reduce housing loan growth by -1.5%.

Commonwealth Bank has disclosed that fewer than 10% of applicants borrow at capacity and fewer than 2% were impacted by the 15 basis points increase in its floor in June. This, in turn, suggests to Morgan Stanley that modest changes to the floor will have minimal impact on loan growth.

JPMorgan calculates, in the June quarter, home loans to borrowers with DTI's above 6x accounted for 24% of new flows for the major banks. There is a tendency to focus on investor risks but, as the broker highlights, ultra-low interest rates also pose issues for owner occupiers as well.

That said, bank disclosures on high DTI lending are very limited and, as JPMorgan notes, so far, New Zealand's mortgage growth has defied a number of attempts by the Reserve Bank of New Zealand to cool the market.

Jarden expects a cap on high DTI lending would have the greatest impact on investors with multiple loans, while an increase in serviceability buffers would likely affect all borrowers.

APRA has previously flagged that counter-cyclical capital buffers can be used to rein in credit growth, yet the banks are holding excess capital at present and, hence, Jarden and JPMorgan assert any increase in capital buffers would not have a meaningful impact in the short term.

Nevertheless, Jarden calculates that increasing the serviceability buffer by 0.5% would reduce borrowing capacity by -5% and directly slow credit growth by -0.5-1% over a 12-month period.

In the end, **given a federal election is expected in early 2022, any tightening is likely to be modest** as a housing market correction in the lead up to an election would be construed as “unwelcome”.

Hence, Jarden agrees a modest but visible measure to take some heat out of the housing market is the most probable scenario. The broker remains positive about the outlook for house prices and credit growth because of continued low interest rates and the improving economic outlook post lockdowns.

Bank Valuations

The main upside for the banks, therefore, is likely to be coming from any macro prudential measures being used to re-price mortgages. In ranking the banks Macquarie notes mortgage fortunes at **ANZ Bank** ((ANZ)) have declined, while losses in terms of market share have accelerated.

Even though the bank has argued that it will not use a price lever to chase market share for its own sake, as growth lags peers by -4.5% Macquarie suspects this could turn out to be a costly mistake, unless margins can compensate. Banks have outperformed the broader market by 4% in September but the broker assesses, in the longer term, there is limited appeal in the sector.

On face value banks are expensive, although when reflecting the current cost of equity in the market the sector becomes only slightly overvalued, in Citi's view. **The market appears to be pricing in an improvement in underlying returns in FY22 and beyond, likely because of higher interest rates and improving deposit margins.**

While the sector may be priced broadly appropriately, there is a divergence amongst banks. Citi believes Commonwealth Bank and ANZ Bank are overvalued, while Westpac and **National Australia Bank** ((NAB)) are only modestly expensive.

While there has been some moderation in bank share gains since May most of the major banks have been re-testing 1-2-year highs. The banks have endured a protracted period of falling returns on equity, complicated by the pandemic ,and Citi concludes the lack of recovery in underlying returns, normalised for bad debts and buybacks, has meant outperformance has stalled.

The broker notes Commonwealth Bank has been the only one to record a modest improvement in underlying returns, to 13.1%, but this has been offset by a sharp recovery in the share price. If a economic downturn does eventuate, the valuation of the sector may make it more susceptible to underperformance compared with the broader market, the broker adds.

See also, Banks Still Face Challenges Ahead on September 8, 2021.

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AUSTRALIA

Digital Australia Losing Competitive Strength

Australian fintechs and neobanks are recording record growth, but the country's digital competitiveness continues to decline relative to global peers.

-A global survey shows Australia's digital competitiveness continues to decline
-Australian fintech and neobank sectors show record growth
-CreditorWatch believes Australia remains a global leader in fintechs

By Danielle Austin

Strong growth in the fintech and neobank sectors in Australia has not been able to halt the nation's continuing decline in digital competitiveness, reveals the IMD World Digital Competitiveness Ranking.

Australia's ranking fell for the third year in a row to 20 out of 64 countries.

The nation did exhibit strengths which could spur digital evolution. These included a strong regulatory framework to support start-ups, software piracy IT integration, and e-government.

Business agility and knowledge transfer between companies and universities ranked particularly low.

The Committee for Economic Development of Australia says fostering collaboration between the business and university sectors is necessary to support investment, innovation and value creation in the tech space.

The Committee says improved digital competitiveness and the leveraging of new technology would yield job opportunities, improve government services, and support decarbonisation and climate-change solutions.

Further, the ranking demonstrates Australia's lack of "future readiness", affecting its ability to sustain digital competitiveness.

The federal government has repeatedly expressed interest in becoming a leading digital economy by 2030, and faces no shortage of opportunities for digital advancement, or opportunities to adopt emerging technologies.

The other side of the coin

The IMD World Digital Competitiveness Ranking results stand in contrast to its other metrics, which highlight strong growth in Australia's fintech and neobank sectors.

While these technologies have long experienced early adoption by younger demographics, regulatory changes are improving their appeal to wider audiences.

Digital financial services globally also benefited from increased adoption during the covid pandemic, as demand for digital solutions rose sharply to support remote workers.

CreditorWatch research shows Australia remains a fintech leader, the number Australian fintech companies increasing to 733 in 2020, from 629 in 2019.

CreditorWatch says the adoption of fintechs can help businesses compete globally, allowing access to new customer segments and markets. Companies that remain engaged with fintech development should lead new financial systems.

Neobanks in the Australia-Pacific region experienced record growth in the first half of 2021. This year, neobanks' total customer acquisitions grew 44.57% and new customer acquisitions 113.62%.

Finbold says growth in the neobank sector has been driven by large tech companies seeking to leverage regional innovation. Increased product offerings and an improved regulatory environment also contributed.

Advancements by fintechs and neobanks are encouraging traditional banks to explore digital trends.

Many legacy banks have introduced in-house fintech capabilities, or formed partnerships with existing fintech or neobank companies to bring new products to customers.

AUSTRALIA

September In Review: First Decline In 12 Months

Losses in the materials sector drove a -1.9% total decline for the ASX200 in September, putting an end to eleven consecutive months of gains for the benchmark.

-The ASX200 retraced -1.9% (total return) during September
-Value outperformed Growth
-Australian 10-year bond yield increased by 34 basis points
-Iron ore prices slumped by -25.2%, following a -14.3% fall in August

By Mark Woodruff

After eleven consecutive months of positive performances, the ASX200 closed out September -1.9% lower on a total return basis (including dividends).

Equity markets had to contend with negative sentiment around China, more hawkish Federal Reserve commentary and surging energy prices. In local currency terms, the MSCI World Developed Market World index declined by -3.6%, largely due to a -4.65% fall in the S&P500 in the US. The equivalent Emerging Market index declined by -2.8%.

Global bond yields surged, with 10-year US yields climbing by 24bps to 1.53%, which contributed to the -5.3% fall for the Nasdaq; its worst month since March 2020. The Australian 10-year bond yield increased by 34bps to 1.49%.

Over the course of 2021, market momentum has switched between 'value' and 'growth' on a number of occasions but **September saw value stocks relative outperforming** by 1.9%. However, it was not a momentum switch across the board with the Materials sector falling by -9.3%, while 'growth' sectors Health Care and Information Technology decreased by -4.9% and -3.9%, respectively.

Meanwhile, the Energy sector rose by 16.7%, Utilities by 2.5% and Financials increased by 1.6%. Hence, it can be concluded the outperformance of 'value' in Australia was broadly carried by the rally in energy stocks, with financials providing additional support.

In large swings on commodity markets, **iron ore prices slumped by -25.2% to $US118.5/t,** while hard coking coal, thermal coal and uranium prices rose by 39.9%, 25.1% and 24.4%, respectively.

ASX100 best and worst

September's best performing stocks were Beach Energy ((BPT)) which rose 42.4%, AusNet Services ((AST)) up 30.2%, Woodside Petroleum ((WPL)) 22.5%, Altium ((ALU)) 19.6%, Santos ((STO)) 18.5% and Oil Search ((OSH)) which climbed 17.4%.

On the flipside, the worst performing were Fortescue Metals Group ((FMG)), which fell by -20.7%, Mineral Resources ((MIN)) -18.4%, Magellan Financial Group ((MFG)) -18.4%, BlueScope Steel ((BSL)) -17.1%, Appen ((APX)) -16.6% and BHP Group ((BHP)) which fell by -12.2%.

Small Ordinaries best and worst

The Small Ordinaries lost -2.1% (total return) in September, with Energy rising by 15.7% and Communication Services by 1.3%, while Materials crumbled by -7.3% and Information Technology retreated by -4.6%.

The outperformers were Flight Centre Travel Group ((FLT)) increasing by 30.8% FAR Ltd ((FAR)) 27.8%, Freedom Foods ((FNP)) 23.7%, Carnavon Petroleum 23.5% ((CVN)) Cooper Energy ((COE)) 20% and Ioneer ((INR)) jumped 14.5%.

Meanwhile, De Grey Mining ((DEG)) fell by -19.6%, Dacian Gold ((DCN)) -18.7%, Champion Iron ((CIA)) -18%, Aurelia Metals ((AMI)) -15.5%, Codan ((CDA)) -15.1% and Capricorn Metals ((CMM)) declined by -13.8%.

Banks

Banks outperformed the broader market by around 4% in September as Value stocks gained from a brusque switch in market momentum, as rising bond yields negatively impacted healthcare and technology names.

Leading the major banks was Commonwealth Bank of Australia ((CBA)) which climbed 4.2%, ANZ Bank ((ANZ)) 1.1%, Westpac Bank ((WBC)) 0.7% and National Australia Bank ((NAB)) up by 0.4%. The share prices of both Bank Of Queensland ((BOQ)) and Bendigo & Adelaide Bank ((BEN)) fell by -1.1% and -3.4% during the month.

Morgan Stanley remains positive on banks in Australia on relative valuation, a resilient earnings outlook, buybacks and the potential for rising dividends.

On the other hand, Macquarie sees downside risk for pre-provision earnings and limited sector appeal in the longer term, though, in the short term, the broker says the sector may enjoy the benefit from rising bond yields and reasonable relative valuations versus Industrials.

Overall, Macquarie has a neutral view on the sector, prefers National Australia Bank and cautions over the valuation premium attached to Commonwealth Bank of Australia.

REITs

REITs were down -2.18% over the month, underperforming the broader ASX200 by -0.3%.

Credit Suisse remains generally positive on the sector and reiterates that balance sheets remain in good shape. However, as share prices have rallied over recent months, the broker now has generally modest expectations for returns.

On an individual REIT level, the broker is attracted to the low gearing and outlook for earnings growth for the fund managers Charter Hall Group ((CHC)) and Goodman Group ((GMG)). The broker also sees relative value in the large-cap diversified names of Stockland ((SGP)) and Mirvac Group ((MGR)), while Charter Hall Retail REIT ((CQR)) is the preferred exposure for retail.

Outperformers over September included those REITs with retail exposure including Charter Hall Retail REIT, Scentre Group ((SCG)) and GPT Group ((GPT)), while Goodman Group and Centuria Industrial REIT ((CIP)) underperformed following previous sharp outperformance.

Asset Managers – for the September quarter

In a mark-to-market exercise for ASX-listed asset managers under its coverage, Jarden awards both market and foreign exchange (FX) marks by determining regional exposures.

While slightly weaker markets were a setback for funds under management (FUM) balances overall, foreign exchange tailwinds helped managers with US exposure, explain the analysts.

The broker estimates an overall -1.7% FUM mark for Janus Henderson Group ((JHG)), driven by exposure to UK/European markets. Meanwhile, a sizeable exposure to US markets also impacted FUM for Magellan Financial Group ((MFG)) though this was somewhat alleviated by FX tailwinds.

FUM marks across other asset managers were more moderate, with Perpetual ((PPT)) up by 1.2% after benefitting from the falling Australian dollar, given its Barrow Hanley acquisition.

Jarden makes limited changes to EPS estimates and 12-month target prices, and maintains ratings as follows: Pendal Group ((PDL)) Buy, Neutral for Challenger ((CGF)) and Underweight for Magellan Financial Group, Perpetual, Janus Henderson Group and Platinum Asset Management ((PTM)).

Commodities

The CRB Commodity Index increased by 4.9% over September to close at 229.

Brent crude oil rose 7.6% to US$78.5/bbl.

Iron ore prices slumped by -25.2% to US$118.5/t.

The gold price declined by -3.1% to US$1,743/oz, while in base metals aluminium rose 5.2%, copper fell -6.1% and nickel slumped by -8.2%.

A special mention goes to **hard coking coal, thermal coal and uranium** whose prices rose by 39.9%, 25.1% and 24.4%, respectively.

Interest rates

The Australian 10-year bond yield increased by 34bps to 1.49%, while the 10-year US yields also climbed by 24bps to 1.53%.

Foreign Exchange

The US Dollar Index (DXY), a measure of the value of the US Dollar relative to a basket of foreign currencies, closed up 1.7% in September at 94.23.

The Australian dollar declined by -1.2% during the month to close at US72.23c.

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AUSTRALIA

Magellan Financial Tests The Faith

More than a few eyebrows were raised yesterday when Magellan Financial Group's September quarter data revealed a dramatic outflow of funds

-Cracks showing after a year of underperformance at Magellan Financial Group
-Hard to stage a comeback from here – but not impossible
-Pressure expected to remain for several quarters

By Sarah Mills

More than a few eyebrows were raised yesterday when Magellan Financial Group ((MFG)) announced its September quarter funds under management (FUM) data.

FUM fell -$4bn to $84bn in its Global Equities fund after investors switched allegiances in response to the fund's poor performance.

Net institutional outflows rocketed to -$910m in the September quarter from -$91m in the June quarter as three clients rebalanced portfolios; and retail outflows jumped to -$617m from -260m.

Net flows in other segments were stable.

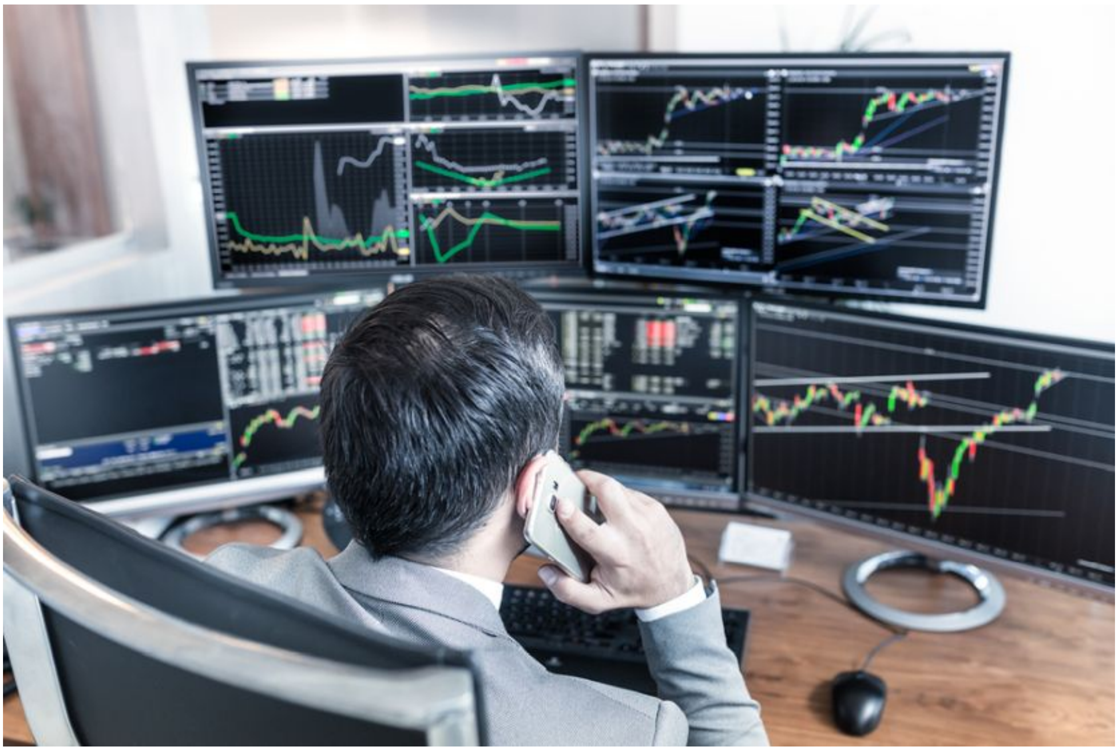
Most of the outflows were clocked in the month of September, so while FUM rose 11% on the previous year, it fell -$600m in September.

Credit Suisse suggests the outflows in isolation are only likely to reduce earnings by only -1% to -2% in FY22-24.

But should investors turn tail in search of greater opportunity, or should fees be reduced, both would result in material falls in earnings per share.

Morgans reports that every -10 basis point fee reduction translates to a -3.8% fall in EPS but says a fee reduction is unlikely for this very reason.

While Credit Suisse expects institutional investors will continue to support the stock given downside protection, the broker expects this to be outweighed by redemptions relating to weak performance.



Key drivers suggest pressure on fees

The outflows reflect a year of underperformance. The fund has posted its worst run on record, underperforming the benchmark in 10 out of 11 months, reports Macquarie.

Credit Suisse reports the Global Fund's has under-performed by about -19% over one year.

About 23% of net retail outflows relate to redemptions from the High Conviction Trust when it was converted to an open-end active exchange-traded fund, providing an opportunity for investors to exit.

At face value, this is likely a one-off occurrence, but sentiment could snowball.

Credit Suisse doubts retail outflows will slow, forecasting continued deterioration over the next three years.

Nearly all brokers believe the likelihood of continued outflows means the pressure on the fund to drop performance fees this half is very high.

Morgans reports Magellan's fees are at the upper end and less defensible given underperformance.

Magellan explains

Magellan advised the market that FUM flows no longer drive the economics of the business and that absolute performance is, instead, the unit holders' focus.

That may be the case, but sentiment often has little to do with economics and sentiment can be powerful driver in an uncertain share market.

In its defence, the fund points out that it lost no institutional mandates in the quarter of FY22, and has gained its first two mandates for its new Sustainable strategy.

Ord Minnett expects Magellan's best-in-class distribution function will be tested as it defend its funds under management as will its investment style of attracting low downside capture.

The broker suspects that the fund might be best off using its dividend reinvestment plant to reinvest in the share price rather than add incremental capital.

Outlook weak as challenges compound

Most brokers spy strong valuation support, but expect consensus downgrades as negatives compound and are likely to be unavoidable should performance fees be lowered.

Investor fatigue, continued pressure on outflows and pressure on performance fees could feature during the FY22 first-half.

Most expect no revival for several quarters.

Morgans reports lack of traction in strategies to drive FUM growth and growing fee pressure, but sees fee reductions as unlikely.

Still, things can turn on a dime

The fund has been purchasing deeply discounted growth companies in a year of rotation out of growth and into value. A reversal in FY22 could revive fortunes.

But the falls are set against high market uncertainty; the Fed intimating rate rises as supply-driven inflation hits the economy, deleveraging in China as the Evergrande concerns weigh on the market; and a flood of global debt.

During FY21, the fund invested in investment bank Barrenjoey, financial services provider FinClear and food chain Guzman y Gomez.

So the majority of brokers have plumped on the side of caution, despite nearly all appreciating the stock's low valuation (the stock is trading on a price-earnings multiple of 13x).

Fund manager WAM Capital ((WAM)) recently bought in to the fund for that very reason.

Forecasts vary sharply

Macquarie was the notable positive exception, upgrading the fund to Outperform from Neutral citing the 7% dividend yield and downside protection, but has cut its target price to $38.00 from $46.75.

The broker describes the fund as bent but not broken, expecting one-year metrics should improve after November but still underperform benchmarks.

Morgans downgrades from to Hold from Add, and cuts its target price to $42.85 from $54.85, waiting for sentiment to play out before committing.

Ord Minnett retains a Hold rating and cuts its target price to $36.00 from $48.50.

Credit Suisse retains a Neutral rating, expecting the Global Fund will continue to underperform and reduces the target price to $35 from $37.

Morgan Stanley retains its Underweight rating and $34 target price.

UBS retains its Sell rating and lowers the target price to $29 from $35.

The FNArena broker database is split two Buy, two Hold and two Sell (or equivalent) ratings. A consensus target of $37.81 suggests 17.8% upside.

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BOOK REVIEWS

Book Excerpt: Shareplicity 2, A Guide To Investing In US Stock Markets

Edited excerpt from Shareplicity 2, A guide to investing in US stock markets: Secular Growth Megatrends & The S-Curve

By Danielle Ecuyer, author

Chapter 5 Secular growth megatrends: Part one - an overview

If you are not familiar with the term 'secular megatrends', then put simply: secular growth is a fundamental change in a sector that creates strong long-term demand for a new product or service, that well exceeds the traditional cyclical upturns in economic activity; and let's leave it to Macquarie Bank's global equities strategist and big thinker Viktor Shvets to define megatrends:

> 'Robotics, cloud computing, AI and 3D printing are revolutionizing energy, manufacturing and consumption. Beyond atoms lies the singularity (the inability to differentiate between human and non-human contribution).' (From his book *The Great Rupture*.)

Viktor Shvets belongs to a group of experts who assert that we are on the cusp of the greatest technological innovation and disruption with the rollout of the 21st century's secular megatrends over the next two decades and beyond.

I want you all to envisage autonomous robotaxis, smart appliances, smart clean energy systems and digital bitcoin wallets. All these innovations include or are part of the acceleration of DANCE, an acronym which stands for the growth business sectors of data, algorithms, networks, cloud computing and improved digital hardware. The lines between traditional hardware and software businesses are becoming increasingly blurred as smart hardware embraces cloud-operated software as a service (SaaS). As technology analyst Laura Martin stated:

> 'AAPL (Apple) should be valued as an ecosystem company owing to its seamless integration of hardware, software and content, we believe.'

Yes, I can hear the guffaws of doubters and naysayers, but I wager that you will make more money by investing in the winning companies – or the 'best in breed/sector/class' of change-makers – in the second decade of 21st century megatrends than buying mature businesses in cyclical sectors.

Secular Growth trend

Ecommerce is a great example of a secular growth trend. Online retail sales in the US have grown from around 0.5% of total retail sales in 1999 to around 20% by the end of 2020.

Secular trends can be impacted by changes in economic activity of a more cyclical nature but are generally perceived to be more resilient than traditional, cyclical business models and sectors, as demand can be sustained or grow during economic downturns (this is due to disruption or switching when consumers change from the older business to the newer one). In the case of the pandemic, a mix of enforced lockdowns and limits on discretionary expenditure for travel, tourism and the like substantially increased demand for online services and goods, reducing demand away from traditional bricks and mortar (physical shops).

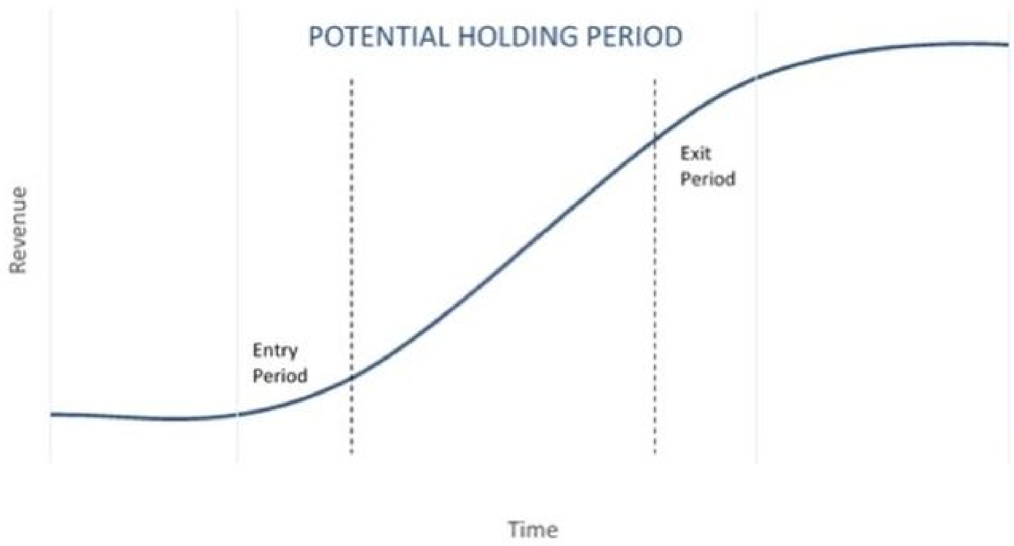
According to James L. Callinan from Osterweis Capital Management, there are three drivers of secular growth:

1. **Foundational technology:** This is the most profound innovation and change maker. There are many examples over history, where technology not only allows for the evolution of a new marketplace, but also many businesses and other technologies can leverage or build from the innovative development. Examples include electricity from combustion engines and, more recently, ecommerce from the internet.

2. **Replacement product, existing market:** This is relatively self-explanatory: technology allows for the development of a replacement product or service that challenges the incumbent legacy producers. Companies use these products and services to grow their sales and market share – and erode the market share of existing players. They do this by offering cheaper, more efficient or better services or goods; or those that meet changing market dynamics. I don't want to sound like a broken record, but the electric vehicle is a current example. In bygone days, it was the dishwasher or washing machine.
3. **New product, new market:** Osterweis cites Google as a great example of a new service (providing search and advertising engines) that was founded and built upon what was a new communications and information transfer network, the internet. Google's market share has grown to 92% of all internet searches, having wiped out the competition since the early days of the late 1990s. Arguably, with such market dominance, a company like Google is attracting not only possible regulatory intervention but, also, its growth has moved from secular to cyclical (as it benefits from an uptick in advertising spend). When companies achieve market dominance, the ability to further grow revenue and earnings becomes more dependent on economic cycles and the ability to innovate and adapt.

This leads to what we are looking for in secular growth companies, the 'S' curve.

FIGURE 9 The S Curve



The S curve shows sales revenue from a new business model. Initially, it takes time for the product or service to develop and sales to grow, but once the adaptation, demand and popularity increases, sales have the potential to grow very strongly (see the mid-section of the curve in Figure 9). If the company fails to change and adapt through reinvesting, then it is likely the sales of the once innovator or change maker will slow down, as shown by the flattening of the curve.

The valuations given to companies on the S curve will change over the course of the curve as well. For example, in bull markets such as we saw in 2020, there was a lot of liquidity generated by the Fed and most secular stocks rose, and often rose steeply, even if the business was at the entry point. This meant investors were giving the company the benefit of the doubt in terms of its future growth potential, referred to as a 'long earnings tail' when earnings come well in the future. If the market thinks a stock will grow its revenue and earnings at a high compound average growth rate (CAGR), the total addressable market (TAM) is huge. In bull markets, with low interest rates, these stocks will be given crazy-high valuations, equal to and in excess of 50x a price-to-sales ratio. Investors may well look back at these valuations as excessive 'bubble'-like multiples in a low interest rate world.

Many of the growth S curve start-ups have no reported earnings and their valuations are derived from the price-to-sales (revenue) multiple. (Valuation metrics will be explained in more detail later in this chapter and in chapters 6, 8 and 9.)

However, if there are any indications of a slowdown in revenue growth (either reported or indicated via the company's outlook), the stock price is normally sold down heavily. This means a stock's valuation will either contract or expand depending on whether the company can successfully execute the next phase of high revenue growth to penetrate the large TAM.

Danielle Ecuyer has been involved in share investing in Australia and Internationally for over three decades. Due to the success of her first book ***Shareplicity: A simple approach to share investing (Major Street Publishing $29.95) her second book Shareplicity 2 A guide to investing in US stock markets (Major Street Publishing $34.95) was published in July 2021.*** **Find out more at www.shareplicity.com.au**

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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COMMODITIES

Material Matters: Commodity Positioning

A glance through the latest expert views and predictions about commodities: commodity positioning; gold equities; copper; and gas/oil.

-A sharp recovery in commodity prices from recent falls is unlikely, UBS asserts
-Gold under pressure; time to buy gold equities?
-Constraints on metal consumption and demand declines make Citi more bearish on copper
-Australia's east coast gas pricing remains disconnected from booming international prices

By Eva Brocklehurst

Commodity Positioning

Very recently the outlook for commodity demand has deteriorated, UBS observes. The financial problems of Evergrande have triggered a slowdown in China's property sales while **power** shortages and rationing have impacted industrial activity materially since July.

The demand impulse in developed markets has peaked and demand is changing to services from goods. Near-term supply constraints in smelting and refining in China are providing some offset while central banks are edging closer to hiking rates.

Hence, UBS asserts this is not the backdrop for a sharp recovery in commodity prices, which should fall further over the next 12 months. Therefore, it is too early to be a buyer and the broker remains underweight on the mining sector with predominantly Sell or Neutral ratings across its coverage.

UBS prefers **thermal coal, nickel, aluminium and lithium** at this stage. Thermal coal appears resilient while electric vehicle-related demand remains strong and should support nickel and lithium. The structural outlook for aluminium has also improved, although the broker does not believe spot prices are sustainable.

Meanwhile, the fundamentals for **iron ore** are considered challenging and UBS envisages further downside in prices. **Gold** provides a hedge against inflation risks but the broker points to rising yields and policy normalisation that should pressure prices.

UBS maintains a Sell rating on **Rio Tinto** ((RIO)) while in contrast a Buy rating is held for **South32** ((S32)) as it has a more attractive suite of commodity exposures.

<u>Gold Equities</u>

Gold has been under pressure since the recent US FOMC (Federal Reserve Open Market Committee) meeting, falling below US$1750/oz as US10-year yields temporarily rose above 1.5%, Macquarie observes.

Adding to the list of uncertainties, the broker includes FOMC member resignations, a need to re-appoint the Federal Reserve chair and issues over the US debt ceiling. Macquarie expects the first hike in US official rates in the fourth quarter of 2022.

Movements in gold prices present a key risk to the broker's base case for gold stocks, while variations in operating costs and capital expenditure budgets also have an impact.

KCMG represents the largest signal catalyst in the broker's net asset valuation (NAV) for **Northern Star** ((NST)) with operating improvements and underground additions also important. Meanwhile, the extension of the mining licence at Simberi is key to unlocking the full potential of the sulphide project for **St Barbara** ((SBM)).

Ord Minnett envisages opportunities within the gold sector following recent equity performance and initiates coverage on seven gold stocks. Volatility has not been a help and the labour environment adds risk to company guidance targets for FY22.

There are also company-specific factors influencing individual stocks so the broker suggests investors be selective and focus on those with strong fundamentals and exploration potential.

Ord Minnett initiates with Buy ratings on Northern Star, **Silver Lake Resources** ((SLR)), **Gold Road Resources** ((GOR)) and **Red 5** ((RED)), all of which are expected to improve their business fundamentals over the next 12-24 months.

Accumulate recommendations are placed on **Evolution Mining** ((EVN)) and **Ramelius Resources** ((RMS)), both of which are considered having "safer" liquid gold exposure, while a Hold rating is applied to St Barbara.

The broker believes net asset valuation (NAV) calculations on their own underestimate the real value of a miner by relying on a mine plan that is backed by reserves. Hence, a risked valuation methodology is included. Using this framework, the broker acknowledges it is more difficult to assess those with exploration potential, such as Gold Road, until new discoveries are made and at least classed as inferred.

<u>Copper</u>

Citi has become more bearish about the price outlook for **copper** in the short term, lowering its forecast for the fourth quarter to US$8600/t. Negative developments include a rapid increase in coal, **gas** and power prices, which has an unfavourable impact on Chinese and global supply chains.

There is an ongoing shortage of chips and containers, which constrains metal consumption and puts upward pressure on costs. China appears to be consuming copper well ahead of supply so the market remains in a small deficit. This prevents the broker from becoming too bearish for the short term. Citi contends, as demand declines over coming months, the market should re-balance.

The broker emphasises its strong belief in a copper super cycle and over the next three-to-six-months suspects there is an opportunity to buy into the market. The base case is for copper to trade up to US$9500/t by the middle of 2022, supported by decarbonisation-related consumption as well as greater supply of chips, power, containers and global manufactured goods.

<u>Oil/Gas</u>

Citi upgrades global gas price estimates and slightly downgrades **oil**. The gas upgrade follows increased demand ahead of the northern winter amid no supply response until 2022. Citi upgrades December quarter Henry Hub and JKM prices to US$6/MMBtu and US$28.80/MMBtu, respectively.

The probability between the broker's base and bookcases is narrowed given the uncertainty about the severity of the northern winter and heightened risk of supply disruptions from the Atlantic hurricane season.

Nevertheless, Citi points out high international gas prices are not translating into higher domestic producer prices. This is caused by the uneven supply/demand balance which is expected to persist into 2022. The main issue is reduced gas demand for power generation, which has fallen by -28% in the September quarter.

The loss of this gas demand is largely associated with rapid increases in renewables as well as demand destruction from the pandemic. There is an excess of gas in the Australian market which is unable to be exported via LNG terminals.

This problem effectively disconnects the domestic market from JKM pricing. The ACCC netback for east coast gas suggests domestic prices should be around $22/gigajoule in October yet, at the Wallumbilla hub, gas is trading at just $8/gigajoule as of September 30.

In downgrading oil, Citi reduces fourth quarter Brent price forecasts to US$74/bbl following weaker-than-expected drawdown in the third quarter. 2022 Brent forecasts are unchanged at US$67/bbl.

In this scenario the broker finds **Beach Energy** ((BPT)) best placed to capture the long-term upside from oil. Over a shorter horizon, **Woodside Petroleum** ((WPL)) is the most leveraged to the oil price while **Senex Energy** ((SXY)) offers the best downside protection.

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COMMODITIES

Material Matters: Energy & Copper/Aluminium

A glance through the latest expert views and predictions about commodities: coal; energy; Oz energy stocks; and copper/aluminium

-Coal prices likely to remain higher for longer
-High-priced gas signals potential rise in oil usage in northern winter
-Opportunities prevail in ASX energy stocks
-Demand for copper/aluminium hit by power rationing/restrictions in China

By Eva Brocklehurst

Coal

Globally, seaborne **coal** shipments are actually down slightly over the year to date. UBS has accumulated data that shows higher shipments from US producers, up 22%, and slight rises from Indonesia and Australia, up 2% and 1%, respectively, are offset by Russia, down -17%, Canada down -8% and South Africa down -7%.

Thermal coal prices have continued to rise, reaching US$230/t in the week to October 1, and UBS has materially upgraded 2021-23 estimates to reflect tightness across the energy complex, as **gas** shortages lift demand. Prices are expected to remain elevated in 2022 amid limited supply growth and low inventory.

Metallurgical (coking) coal prices ex-Australia remain relatively flat, at around US$390/t. Prices have risen steeply over the year because of tight supply fundamentals and strong **steel** output. This is expected to continue amid supply constraints and weak imports from China.

For the longer term, the broker suspects coking coal prices will hold near the marginal cost of production at around US$150/t, although remains unsure about the enduring fundamentals because of an increased focus on **carbon** emissions.

Energy

The new energy dynamic continues to play out as ESG considerations and **renewables** investment increasingly trump investment in traditional energy sources, Petra Capital asserts.

The analysts expect heightened international gas prices into the foreseeable future. Why? This time around mass substitution for high-priced gas is unlikely as coal prices are also at all-time highs and a lack of coal feedstock is emerging in China and India. Asian **LNG** and European gas prices are US$30-35/MMBtu, representing a tenfold increase over the past year.

What may happen, the analysts suggest, is a switch to **high sulphur fuel oil** and **diesel** for **electricity** generation, particularly in developing economies which favour cost economics over ESG considerations. This in turn is likely to boost refining margins and improve **crude** demand.

JPMorgan, too, suspects this may be the case and increases its 2021 Brent crude target to US$84/bbl on gas-to-oil switching. In response to such expectations, the broker notes oil prices have been rising.

At current gas prices and assuming normal winter conditions in the northern hemisphere, the broker expects a 550,000 b/d boost in fuel oil demand for power generation, mostly in Japan and elsewhere in Asia.

In North America, the broker assesses the US natural gas price would need to double from the current US$5.70/MMBtu to trigger gas-to-oil switching but could add another 175,000 b/d of combined demand from the US and Mexico.

Still, the broker believes downside risks for oil are under-appreciated. News has filtered through that cargoes of Middle Eastern and Kazakh crude oil are going unsold because these regions are unable to connect with their normal Asian buyers. This confirms Chinese refiners are cutting runs or going into maintenance, in the broker's view.

In light of this, and weakening physical market indicators in China, JP Morgan does not envisage an incentive for the OPEC alliance to boost oil production beyond current commitments.

Australian Energy Stocks

The ASX200 energy index is up just 7% over the past six months despite the rally in Brent and a huge rally in spot LNG so Petra Capital believes this presents opportunities throughout the domestic market. Petra notes QCLNG, GLNG and APLNG are running at 75-95% capacity signalling Australia's gas market is tight.

Among the major producers, Petra considers **Woodside Petroleum** ((WPL)) the most sensitive to rising LNG spot prices. Others with significant leverage include **Senex Energy** ((SXY)) and **Blue Energy** ((BLU)). Among the small caps, **Horizon Oil** ((HZN)) is most leveraged to higher oil prices.

In marking to market, JPMorgan increases its Brent price forecasts, now forecasting an average of US$73/bbl in 2022 and US$70/bbl in 2023/24. Long-term oil price assumptions from 2025 onwards are unchanged US$60/bbl.

As a result, on average, the broker's net profit estimates for Australian oil producers increase 21% in 2022. Preferences are for **Santos** ((STO)), for its diversity, robust balance sheet and growth options, **Beach Energy** ((BPT)) for leverage to east coast gas prices and a strong balance sheet, and Senex Energy for exposure to east coast gas.

Copper/Aluminium

Credit Suisse notes **copper** demand in China turned negative in June, a probable consequence of the property downturn. Subsequent power rationing is also likely to have a greater impact on demand from fabricators as opposed to supply from smelters and so the broker suspects this will exacerbate the contraction in demand.

As a result, Credit Suisse believes copper may finish the year relatively balanced yet maintains a forecast of a surplus and price of US$3.40/lb in 2022. The broker assesses the tightness in copper mine supply is fading albeit supply is not yet back to the levels of 2013-19.

Meanwhile, **aluminium** demand has also turned down in China and Credit Suisse suspects prices in China may ease later this year. Production restrictions have hit the downstream demand as aluminium plate/sheet companies in several provinces are forced to cut or halt production.

Yet restrictions for smelters are still expanding so supply should remain tight. On the other hand, the broker suspects aluminium is in deficit globally already. Hence this is its pick of the base metals, given medium-term fundamentals and as China reaches its capacity cap.

After that, primary aluminium demand growth will need to switch out of China. Credit Suisse cannot envisage sanctioning of a new smelter any time soon or where a green power source can be obtained. Hence, primary aluminium supply is likely to be constrained by decarbonisation.

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ESG FOCUS

ESG Focus: ASX Heavyweights Showcase ESG Credentials

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ASX Heavyweights Showcase ESG Credentials

Some of the ASX's large cap, household companies are demonstrating commitment to environmental, social and governance concerns through strategy integration.

-Big businesses are increasingly expected to show transparency around ESG measures
-Incorporation of ESG as a key strategic priority is becoming more common for businesses
-Westpac, ANZ and BHP have all provided updates on ESG progress and additional measures

By Danielle Austin

Corporate Australia is becoming increasingly transparent about its adherence to environmental, social and governance (ESG) measures in response to mounting expectations from customers and shareholders.

Recently Westpac ((WBC)), ANZ Bank ((ANZ)) and BHP Group ((BHP)) all provided updates on progress meeting ESG-aligned targets and how ongoing company strategy is integrating ESG measures.

Both banks demonstrated a commitment to a range of ESG measures, highlighting work done to encourage women in leadership roles and a range of climate targets. ANZ Bank also raised particular concerns around rising household debt. BHP, meanwhile, offered a large focus on environmental concerns.

A common thread throughout company updates was the undertaking of a holistic approach, particularly in achieving environmental targets. The companies outlined how leveraging influence and resources and working with other businesses, or supporting customers, would help to achieve targets.

Westpac

Westpac already has a track record of work in the environmental space, but announced an elevation of climate change to a key strategic priority for the company. The bank reiterated its sustainable financing commitment, offering sustainability-linked loans to support customer transition to a low carbon future. Other actions discussed included:

-Exiting all thermal coal exposure in their lending portfolio by 2030
-Supporting existing oil and gas sector clients with transition pathways
-Only lending to new oil and gas sector clients that have Paris-aligned goals
-Reducing the carbon intensity of its electricity generation exposure by -28% by 2030

In the social and governance spaces, the company is committed to taking key steps to achieve 50% women in leadership and improve female retention with pay equity and improved parental leave policies.

Additionally, the bank acknowledged work to be done in enhancing cultural diversity and indigenous representation, particularly in leadership.

ANZ Bank

ANZ Bank focused on outlining how incorporating ESG measure into its strategy would create additional value for both customers and shareholders.

To demonstrate its commitment, the bank's update focused on sustainable finance and financial wellbeing, including positive impact on household debt, and the identification of risk categories within the ESG space including biodiversity, cyber-scamming and economic disparity.

The company highlighted it had beat its women in leadership target for FY21, with women accounting for around 34.8% of leadership roles.

Addressing climate risk, ANZ outlined goals that included:

-Encouraging bank customers to identify climate risk and opportunity
-Supporting the electrification of transport supply chains
-Financing energy efficient buildings
-Providing support to transitioning industries and helping customers develop transition plans
-Reducing emissions produced by bank operations

BHP

Emission reduction targets were already a part of BHP Group's story, but the company has determined that strategy and capital decisions going forward will integrate climate scenarios. BHP also plans to develop biodiversity strategies and FY30 targets aligned with biological diversity.

Already committed to reducing operational emissions -30% on FY20 levels by 2030, BHP's latest update has Australia's largest company on track to meet targets. In the shorter term the company expects to maintain operational emissions in the current financial year at, or below, FY17 levels.

The company also announced an update to its emissions reduction investment, increasing total cost commitment to US$1bn by 2025.

Its greenhouse gas emission targets include reductions in scope 1 emissions (direct emissions, or emissions created as a direct result of company activity), scope 2 emissions (indirect emissions, or emissions generated through the purchase of energy such as electricity), and scope 3 emissions (indirect emissions linked to the business' operational chain, such as those generated by transportation and distribution).

BHP also estimated a US$2-4bn spend on steel carbonisation by 2030, working with key partners to decrease scope 3 emissions.

Further actions to achieve climate targets include:

-A migration to renewables and move away from diesel fuel use
-Achieving 50% renewable electricity in Queensland coal and up to 50% renewable electricity at Nickel West
-Development of zero greenhouse gas emission haul trucks

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ESG FOCUS

ESG Focus: Fed Eyes Climate Stress Tests for Banks

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ESG Focus: Fed Eyes Transition Stress Tests For Banks

The US Federal Reserve is joining the push to stress-test banks for climate risks; a push that will force banks to potentially lay aside trillions in capital; apply further pressure to fossil-fuel producers; and help build macro and micro economic insight into the transition to build policy responses.

-Capital shortfalls for some banks will be substantial
-Bank risk to be coupled to country risk
-Focus is on transition risk over physical or liability risks
-APRA publishes latest info on bank climate vulnerability assessments

By Sarah Mills

The US Federal Reserve Bank of New York, which is the Federal Reserve's and US Treasury's money manager, has published a model for stress-testing big banks' climate exposures.

If applied, the model will likely result in banks being required to lay aside greater capital to support their oil and gas assets, raising the cost of capital for holding fossil-fuel assets.

Morgan Stanley has estimated these capital shortfalls will, for some banks, be "economically substantial".

Using one bank as an example, *Banking Dive* estimates the amount of capital Citi would have to set aside under the CRISK measure (systemic climate risk, which is the expected capital shortfall of a financial institution in a climate stress scenario) soared to US$73bn last year.

Steps to implement climate stress tests for banks are already under way in other nations, well ahead of the Fed, as Europe pushes to lead the global transition and establish market dominance in a new energy order.

The Network of Central Banks and Supervisors for Greening the Financial System comprises 89 member countries.

The cost to banks of laying aside extra capital could be passed on to fossil-fuel companies, adding higher funding costs to the risk of stranded assets for shareholders in fossil fuels.

Alternatively, the banks could spread the capital imposts across the banks' broader portfolios, or the banks could internalise the costs, hitting bank shareholder profits.

Whichever way, it would suggest rising costs for businesses and consumers until the transition is complete.

But banks stress tests are unlikely to happen any time soon, Morgan Stanley noting the paper's findings are likely to be implemented between 2023-2025.

The Fed research paper sets out a method for identifying assets vulnerable to climate shock and then calculating the likely resulting capital shortfall.

<u>Bank risks to be coupled to country risk</u>

Banking Dive reports that the paper also stressed the likelihood of reassigning or coupling bank-level CRISK to country level CRISK, increasing pressure on governments to regulate on climate, and providing deeper macroeconomic insight given transition risks extend across most sectors of the economy.

Sovereign laggards would likely suffer credit-rating downgrades and higher funding costs.

Not surprisingly, Federal Treasurer Josh Frydenberg recently warned Australia has much to lose if we are not transitioning swiftly, clearing the path for Prime Minister Scott Morrison for the COP26 in Glasgow.

"Australia has a lot at stake," says Frydenberg in a speech to the Australian Industry Group. "We cannot run the risk that markets falsely assume we are not transitioning in line with the rest of the world."

<u>Paper examines transition risks only and notes risks are systemic</u>

Climate change affects banks in two main ways: transition risks related to government climate regulation; and physical risks to bank assets such as flooding and drought. Liability risk is also a threat.

The paper addresses transition risks, not physical risks, but Reuters reports the latter may be addressed in future. Transition risks are easier to verify than physical risks.

The Fed applied the model to 27 of the biggest global banks, which supply 80% of loans to oil and gas companies.

The paper's authors found that while the effects on individual banks varied, they were highly correlated, pointing to systemic risk.

While this conclusion may appear self-evident, the paper represents the first step in a process.

The paper found climate risk also tends to move in tandem for large banks from the US, Canada, UK, France and Japan.

The research outlined a measure for transition risk, using stranded asset portfolio returns as a proxy for transition risk, as well as the likely effects of regulation such as carbon taxes.

The authors propose a measure called CRISK: the expected capital shortfall of a financial institution in a climate stress scenario; and notes this measure rose sharply in 2020.

This is not surprising given the jaw-breaking punch covid delivered to oil price volatility last year. Whether the CRISK measure reflects this non-climate-related skew is unclear.

Morgan Stanley reports CRISK is calculated as a function of the firm's size, leverage and expected equity loss relating to climate stress.

The Fed news will come as no surprise to the banks, which have been reviewing their portfolios for climate exposures for years, given the writing has been on the wall.

APRA calls on five largest banks to conduct risk assessments

In early September, the Australian Prudential Regulation Authority published details of the climate vulnerability assessments (CVAs) that Australia's five largest banks are conducting in response to APRA's call in April (the Big 4 and Macquarie Bank).

Given Australia is a fossil-fuel based economy, one imagines the amount of money banks will be required to set aside under the Fed's scenarios will be substantial.

The CVAs require banks report on the financial impact of climate on income statements, cash flow statements and balance sheets.

APRA advised that the CVAs could also be applied to the superannuation and insurance sectors and may be of use to other non-financial enterprises in Australia.

APRA adds liability risk to transition and physical risk in its assessments.

A link to the Fed paper is available here: https://www.newyorkfed.org/research/staff_reports/sr977

A link to the APRA paper is here: https://www.apra.gov.au/climate-vulnerability-assessment

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FEATURE STORIES

Equity Strategy: Awkward Adolescence

While the pace of the global economic recovery has slowed, the next step is another move out of covid-driven restrictions. What is the path from here for global and Australian equity markets?

-Slower pace, bumpier road ahead for global economy
-Chinese policy a significant risk
-Equity market rotation back on the cards
-Inflation possibly the biggest risk

By Greg Peel

"The post-lockdown recovery has transitioned from energetic youthfulness to awkward adolescence," suggests Russell Investments. "It's still growing, although at a slower pace".

When the world went into lockdown last year, global equity markets were already bouncing hard out of March's covid-crash depths, as investors sought to take advantage of panic-driven oversold conditions. By July, the S&P500 had recovered all losses.

The gains were driven by the stay-at-home theme, for which technology is the dominant factor. The surge in online shopping, video streaming subscriptions, video-conferencing, work-from-home equipment and even home delivery meal services provided strong tailwinds for both the technology sectors and traditional businesses with established tech capacity, such as online retail.

Technology-based sectors dominate the S&P500, and Big Tech names dominate technology. While many Australian companies were also able to ride the stay-at-home wave, the locked-down Australian economy wallowed amidst weak commodity prices. It was not until April this year that the ASX200 recovered March 2020 losses.

When last year's lockdowns ended, it appeared the developed world had covid under control. Having been the first to enter lockdowns, China was also the first out, and the resumption of demand drove a swift rebound in commodity prices, most notably iron ore, but also oil.

When Moderna and Pfizer announced they had produced vaccines in November, global equity markets took off again. The announcement also happened to coincide with Joe Biden's presidential win, endorsed or accepted by Americans of intelligence.

Economies were surging out of their depths faster than anyone had foreseen, and vaccine faith managed to offset an even more substantial wave of US covid cases into the new year. This was, as Russell Investments describes it, the post-lockdown recovery's "energetic youthfulness" phase.

Then along came delta.

Aside from a bit of a breather from April through to June, the S&P500 took delta in its stride, as the vaccination rollout moved into overdrive. But what delta did achieve was to heavily impact the supply-side of global economies. This led to slower growth and, most notably, inflation spikes, as shortages of wholesale goods and labour made their impact.

And today, continue to make their impact.

The Great Debate

The great inflation debate centres not specifically on whether inflation spikes are "transitory", as transitory has no definition in time, but on whether having peaked, inflation settles back to pre-pandemic levels or to a structurally higher level.

Mathematically, monthly annual measures of inflation must ease as each month cycles away from the deflation brought about by last year's lockdowns and towards the ensuing months of economic recovery. Hence no one is suggesting current elevated levels are here to stay.

It is Russell Investments' view US inflation may remain high over the rest of 2021 but decline in early 2022. The fund manager's models suggest inflation is likely to drop back below the Fed's 2% target in 2022 which implies, if accurate, the Fed is unlikely to make its first rate hike before the second half of 2023.

The Fed's announced tapering program surprised the market by its pace, to be completed by mid-2022 with December assumed as the starting date, but did not lead to an expected "taper tantrum". It was the Fed's post-GFC policy that gave the world the "taper tantrum", yet back in 2015 the timing to completion was almost twice as long as the Chair is proposing this time.

The lack of tantrum can be put down to many in the market believing tapering should already be underway, given the pace of economic recovery. But Wall Street did perceive a hawkish shift in Fed rhetoric, backed up by nine FOMC members forecasting the first rate hike in 2022.

It is that first announced rate hike, most believe, that will spark a true tantrum.

Last month, Citi surveyed over 90 US pension, mutual and hedge funds. Close to 60% of respondents believed inflation would be "sticky" rather than "transitory" and the majority saw the first rate hike in the second half of 2022 or first half of 2023.

JPMorgan also surveyed clients last month. Of those surveyed, 54% said the US August CPI result (5.3% annual) does not change their view on the persistency of inflation, with the balance evenly split over inflation becoming more persistent or less persistent. Supply constraints are the main drive of inflation, and 54% of respondents saw these as being temporary, with 43% believing them to be a persistent feature.

If there is any conclusion to make with regard inflation, it is that at this point no conclusion can be made.

ANZ Bank economists weigh in on the argument:

"Many of the preconditions for a sustained rise in global inflation remain in place: tight labour markets, skills shortages in a range of sectors, high commodity prices, elevated inflation expectations, central bank permissiveness, and supply chain adjustments reflecting reshoring, geopolitics and other influences are common themes across economies. We thus don't view the current spikes in inflation as entirely transitory.

Upside surprises are continuing."

<u>Growing Pains</u>

We can trace inflation spikes back to supply/labour shortages, and those back to delta. It is delta that has disrupted the pace of the global economic recovery.

Of course, the sheer pace of economic rebound from last year's lockdowns was never going to be sustained, and a slowing of pace, or "maturing" of the recovery, was always expected. But such a maturing was supposed to be smooth, not distorted by the re-emergence of a virus the world had assumed it had overcome.

Hence Russell Investments' suggestion of maturing from youth into "awkward" adolescence.

ANZ Bank economists have cut their 2021 global GDP growth forecast to 5.2% from a prior 5.6%, with Asia, Australia and New Zealand having been the most impacted. That said, their 2022 forecast has been upgraded to 4.3%, implying two years of growth well above the post-GFC average.

ANZ's 2023 forecast is unchanged at 3.3%, in line with the post-GFC average of 3.4%.

The conclusion is thus that the global economy still seems healthy, even if peak growth is now passed.

Yet delta has shown the world that targeting "zero-covid" is unrealistic, hence the shift towards "living with covid". For to hold on for zero-covid would mean continuing lockdowns until a period of zero cases is achieved, which would imply an economic disaster down to the household level more damaging than the virus itself.

New South Wales is a case in point, with restrictions to begin easing for the vaccinated next week, despite the assumption such easing will likely lead to a renewed spike in cases just as the trend is easing. Hospitalisations are also expected to spike, but all hope is being placed on vaccination growth warding off hospitalisations in due course.

Victoria is taking a similar path, despite cases not yet having peaked, as world's lockdown record holder foresees not only ongoing economic damage, but lockdown frustration reaching boiling point.

Remember last year, when everyone thought lockdowns were lots of fun?

The truth is restrictions will be gradually eased, not scrapped, and the prospect of returning to pre-pandemic "normal" remains distant at best. Australian governments, federal and state, are risking a more drawn out pandemic at the cost of saving the economy, suggesting the risk of ongoing targeted snap-lockdowns, ongoing restrictions on patron numbers, and not to mention a couple of rogue states which will do everything to ensure they are sufficiently isolated (while welcoming sporting teams).

All of which means the economy's recovery from here will be a bumpy one at best, and we might say "awkward".

Yet while the road might be bumpy, as long as the economy reopens and remains reopened to sufficient extent from here there is no disagreement among economists, and the RBA, the economic rebound out of lockdowns will be swift, as it was last year. Last year the future looked uncertain, but now we have experience to go by.

And this year demand is even more "pent up" than it was last year, having suffered through a longer lockdown this time in NSW, world-record days of lockdown in Victoria and on-again, off-again lockdowns in other states and regions. And this year, a reopening of the international border looms before Christmas.

Household savings rates are no less elevated this time around than last, and this year's lockdowns of frustration appear set to unleash a spending spree even more pronounced.

The announcement of the vaccines last November provided a kicker for equity markets, as noted, but also a pronounced rotation out of the "lockdown winners", in particular tech and other "growth" stocks, and into prior "lockdown losers", such as hospitality, travel and leisure stocks, as well as bricks & mortar retailers, builders and building materials and machinery manufacturers.

These are the "cyclicals" that rely on economic growth, and also "value" because they had been hit so hard in the lockdown period.

But when delta hit, rotation initially reversed, ahead of a period of back and forward as investors were not really sure which side of the market to be on. US bond yields shot up, and then back down again, to complicate the issue.

With delta cases now on the decline in the US, and governments in Australia moving to a "living with covid" stance, the rotation into cyclicals and value and out of growth has re-emerged but as September showed, the road remains a bumpy one.

The China Factor

While the US economy has led the world into the digital age, Australia remains in the iron age. Hence while the slowing down of the world's second largest economy is a threat to the global economy overall, it is less of a threat to the US but a critical threat to Australia.

No economy came screaming out of last year's lockdowns faster than China's, and sooner than elsewhere, which went a long way to driving the commodity price explosion that saw the iron ore spot price reach a record US$220/t. Since late July, the price of Australia's most valuable export has halved, back to levels of one year ago.

The prices of base and other metals and minerals have also pulled back from earlier highs, on the back of Beijing's emission reduction targets, which have forced steep reductions in China's heavy industry output, including smelting and steel-making.

The greatest consumer of Chinese steel is the Chinese construction industry, specifically housing. As ANZ Bank economists note, the recent cycle is the first since before the GFC in which Chinese monetary policy easing has not led to strong rises in property prices. The reason why became clear when Evergrande was at risk of going under, mired in a mixture of over-supply of housing and unmanageable debt.

For some time Beijing has suggested controlling a rampaging property market and stabilising the level of debt as a share of GDP are among its policy targets, but this is the first period in which the effort has been so overt, ANZ notes.

Property has not been Beijing's only target recently. The Chinese tech sector, private tutoring industry, and Chinese billionaires in general have been the target of regulatory attacks, as Beijing strives to maintain a capitalist market within communist principles even at the expense of economic growth.

No individual can be more powerful than the CCP.

In the years before President Xi came to power, Beijing would routinely reverse heavy stock market falls by telling the Chinese the stock market was a good place to make money, and heading off bubbles by telling the Chinese the market was overvalued and speculators would be punished. But Xi appears to be unfazed by a Hang Seng index down -40% since February as foreign investment heads for the hills.

US investors are now split into two camps – those who see the Chinese market's big fall as offering value, and those who believe Beijing's random regulatory crackdowns now make China simply "uninvestable".

For Australian investors, the issue is less so of the Chinese stock market and more a focus on China's actual economy.

Russell Investments expects Chinese economic growth to be robust over the next twelve months, supported by a post-lockdown jump in consumer spending and incremental fiscal and monetary support. One risk, however, is that Beijing remains in the "zero-covid" cohort, immediately reinstating regional lockdowns at the first sign of a new outbreak.

Ongoing regulation is another risk.

ANZ Bank economists note Beijing's policy choices and China's challenges with delta have impacted economic growth materially in 2021. They now expect Chinese GDP growth rate to slow to 4% towards the end of the year, which would be the slowest rate achieved in the modern era (other than during last year's pandemic) and lower than that during the GFC.

For 2022, ANZ sees a slight pick-up to 5%.

A point to note here:

Were China's growth rate to be maintained around 6% each year, that would not reflect linear growth, but exponential growth. For GDP is measured in dollars, so each year 6% growth on the last would imply exponential growth in dollar terms. No economy can sustain exponential growth forever, and while China may still be included in "emerging market" indices the reality is China has well emerged, and its economy is now maturing.

The only economy larger than China's, being the US, has grown at an annual average rate of 3.12% since 1948.

China's property sector is its greatest internal risk, as the Evergrande saga has highlighted. ANZ believes Beijing's efforts to control excess leverage in the property market create "episodic and pocketed problems", not systemic problems. But housing-related lending accounts for around 30% of all bank lending in China, and housing accounts for 70% of household wealth.

The experience of Australia, notes ANZ, is that constraining housing credit at the end of a very long boom has meaningful impacts on economic growth, as other sources of credit demand fail to fill the gap.

Recall that moves to cool Australia's house price bubble the last time around sent Australia's economy into a tailspin, such that in 2016, the RBA was forced to cut its cash rate to a then-record low 1.5%.

The US

While the US economy is likely to sustain above-trend growth into 2022, Russell Investments suggests the easiest gains are now in the rear view mirror as the recovery phase of the business cycle matures.

Strong fundamentals (and zero interest rates) have helped drive the US stock market to new highs, with S&P500 earnings per share reaching to 20% above the previous cyclical high. The Fed will commence the tapering of bond purchases before year-end.

Meanwhile, the White House is putting its economic faith in Biden's ambitious US$3.5trn infrastructure stimulus plan but can't even gain approval from the Democrat side of Congress, let alone the Republicans. Indications are the plan will need to be significantly watered down.

Citi's aforementioned fund manager survey found more than half of respondents believe the ultimate package will be greater than US$1trn but less than US$2.5trn.

There is also the matter of the debt ceiling. Despite stoic (and hypocritical) Republican resistance, history suggests an agreement will be reached at one minute to midnight (figuratively or literally) before the government shuts down.

More than 60% of Citi's survey respondents believe the ceiling will be raised by mid-October.

The flipside of Biden's proposed infrastructure package, and whatever it may ultimately be, is the tax increase planned to pay for it. An increase in the corporate tax rate is never a positive for Wall Street. We recall that when Trump cut the corporate rate all the way down to 21% from 35%, Wall Street took off.

Biden's initial plan was an increase back to 28%. That, too, looks like being watered down, and particularly if the level of planned spending is reduced. Yet Citi's survey showed almost half of respondents expecting a rate of 26-27%, up from a previous majority expectation of 25%.

Wall Street will not necessarily spit the dummy if a tax increase is approved, given the trade-off of infrastructure spending is seen as necessary, overdue, and indeed economically stimulatory. And while 27% may not be as helpful as a generous 21%, it's still a lot better than 35%.

As for financial market investment, consensus is there's little point in investing in US bonds in the next twelve month as the shift towards easy policy reversal is gaining pace across the globe, highlighted by Fed tapering. Which leaves equities as still the best place to be, if only on a TINA basis ("There Is No Alternative").

Consensus on that front is that as delta wanes, the reopening trade that stalled earlier in the year is back on, hence cyclicals/value are preferred over growth stocks.

The general view is that the US ten-year yield will trend towards 2% by year-end. Despite the panic bond yield spikes have caused to date in 2021, particularly for growth stocks, in isolation, 2% is hardly a major threat to S&P500 earnings growth. The long term average is 4.3%, and the US stock market has not performed too poorly over the long term.

Far from it.

In JPMorgan's aforementioned client survey, 70% of respondents said they planned to increase equity exposure and 80% planned to reduce bond duration in the near term.

But in Citi's survey, the average end-2021 forecast for the S&P500 was 4487, which is only 2.8% above Wednesday night's close (October 6). The average end-2022 forecast was 4630, which is up only 6.1% from here and suggests a mere 3.2% gain over 2022.

There is widespread agreement the likes of 20% annual gains will not be seen again anytime soon. In Citi's survey, 62% of respondents saw a -20% correction as more likely than a 20% rally from here. Citi found this "interesting", but does not make it clear whether it's the 62% that is interesting or the implicit 38% that think the opposite (although the number of "don't knows" is not reported).

History tells us clearly that -20% corrections tend to be swift and 20% rallies drawn out, ie "stairs and elevators". Markets never "crash" up by 20%.

Australia

As suggested, consensus has the Australian economy rebounding swiftly out of lockdowns and border closures. The Australian stock market enjoyed eleven straight months of gains until September came along, and October has not started well, but the impact of upcoming reopenings provides hope.

To that end, the global theme of rotation out of growth and into cyclicals/value is as much the advice downunder as it is elsewhere. Underlying that thematic is a preference for risk over defensives.

Despite markets facing near-term hurdles, Morgans advocates “looking through the noise” and sees risk assets outperforming defensive positions over the next 3-6 months.

The broker considers financials, energy, industrials and consumer services are where opportunities lay, and in sub-sector terms, travel, gaming and traditional retail. Covid-winners consumer staples and large-cap online stocks are not preferred.

Assuming no other new variant is going to come along and slap us in the face, China’s economy is the biggest risk. Morgans is thus cautious on the iron ore majors for now.

Household balance sheets are in “great shape”, Morgans notes, presumably with apologies to anyone who has lost their business or job over the past 18 months. This will support the recovery in consumption.

The broker also sees upside risk to dividends (presumably not iron ore miners) as uncertainty from covid clears, keeping payout ratios elevated.

But if you think we’re in for a second leg of stock market surge ahead, a la April 2020 to August 2021, think again. Morningstar’s analysis indicates investors should expect a total annual return from the equity market (share price and dividends) of 8% over the next five years.

That’s down from 10% over the last five years, and 28% over the past year.

Morningstar’s analysis is based on aggregating individual in-house company earnings forecasts, which suggest a slowing in earnings growth to 3% over the next five years compared to 5% over the past five. Morningstar also estimates the earnings yield of the equity market has fallen to 5% from 6% five years ago, given PEs have expanded.

Markets become overvalued if price/earnings ratios (PE) rise because sentiment drives share prices higher than earnings per share forecasts suggest. And vice versa. However since the GFC, and more notably covid, brought about historically low interest rates, what was long considered the neutral market PE between under- and over-valuation has shifted upward given futures earnings are discounted at a lower rate.

That said, Morningstar believes that while a further increase in equity prices may still possibly be driven by further PE expansion, this would be an unsustainable source of equity market returns. It is also possible that expected interest hikes down the track will lead to a reversal in the PE expansion seen in recent years.

That’s the market as a whole, which doesn’t mean individually undervalued stocks cannot still be found. But as a whole, Morningstar believes the high iron ore prices we had seen are unsustainable, and expects mining company earnings weakness to “weigh heavily” on total equity market earnings over the next five years.

From an S&P/ASX stock index perspective, this creates a problem. Most balanced funds, and market ETFs, and other more specific ETFs, invest passively according to index weightings, be it top 20, 50, 100, 200, 300 or All-Ords (500). If the weighting of one stock in any index increases, funds must passively buy more of that stock.

Assuming BHP Group’s ((BHP)) dual structure ends as planned and the proposed merger of BHP Petroleum and Woodside Petroleum ((WPL)) goes ahead, Morningstar calculates BHP’s weighting in the ASX200 would rise to 9% from 5%.

BHP is in every one of the above-mentioned indices, and is not shy of producing a bit of iron ore.

It’s Not Easy Being Green

Nor was BHP once shy of producing oil, but assuming the Petroleum merger goes ahead, the Big Australian will have taken another, major, step away from fossil fuels. BHP is not the only global commodity producer to be moving along this path.

Arguably, 2021 is the year the world woke up to climate change. Not that a “green” shift in government policy only began this year, but after a frightening run of fires, floods, snow storms and hurricanes/cyclones/typhoons, the former laggards in the “net-zero by 2050” push have rushed to join the club.

Those still wavering – we won't name names – are being press-ganged into the club on a risk of losing global credibility, but more so on a risk the exports on which its economy so significantly relies will hit by climate-related tariffs imposed by the true believers.

While the general population of the globe is cheering on this sudden call to action, the world's energy sector is not yet far enough along the path of switching to renewables and away from fossil fuels to make the transition a smooth one.

The end result is contradictory supply-side issues.

The global pace of increasing supply of oil and coal has come to a halt, with the odd exception. Energy companies see the writing on the wall, and have for a while, and no longer see commercial value in pressing on with more exploration and project development.

Banks won't lend to them anyway and institutional investors will no longer touch them, on both a commercial and ESG basis. Dwindling supply is behind the astronomical increases in the prices of oil, gas and thermal coal this year.

At the same time, demand has exploded for commodities supporting the push towards green energy, including uranium, battery elements (lithium, cobalt, nickel), and the copper needed for all the wiring in an electric world.

This interim period between energy investment rising sufficiently to net-out the decline in fossil fuel investment has driven all related commodity prices higher in tandem.

Which equals inflation.

But it's not just commodity price inflation.

2021 could also arguably go down as the year the global finance market lost its pragmatic mind. Never in the history of the world have investors been prepared to pay more for something than they otherwise have to. But this is the cost of ESG.

The shift to "green" (E) at this stage of the game requires a premium. E is the most tangible of the environment, social and governance mix, but investors are also paying a premium for the less tangible S and G, which include everything from board room diversity to tackling social inequality to corporate disclosure.

Investors are not necessarily paying a premium because they've become all gooey and altruistic, but rather to highlight their ESG credentials in a world shifting rapidly now towards such goals.

All of which, again, implies inflation.

The final word to ANZ's economists, in the case of E:

"Climate change mitigation, to the extent it involves action that business, governments and individuals wouldn't otherwise take, seems likely to reduce economic efficiency and hence raise prices in some instances. How inflationary those actions end up being, however, depends on how it is accommodated by policymakers. The shift in the global policy dynamic, particularly when compared with the post-GFC period, suggests the price gains are likely to be sustained."

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WEEKLY REPORTS

Weekly Ratings, Targets, Forecast Changes - 01-10-21

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

By Mark Woodruff

Guide:

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

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

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

Summary

Period: Monday September 27 to Friday October 1, 2021
Total Upgrades: 7
Total Downgrades: 6
Net Ratings Breakdown: Buy 54.11%; Hold 38.17%; Sell 7.72%

For the week ending Friday October 1, there were seven upgrades and six downgrades to ASX-listed companies covered by brokers in the FNArena database.

Morgans (Hold), Credit Suisse (Neutral) and Ord Minnett (Accumulate) all downgraded recommendations for SmartGroup Corp last week from Add, Outperform and Buy, respectively. This was in reaction to a non-binding indicative offer from US private equity firm TPG Global and Potentia Capital (consortium) for $10.35 in cash. The price was generally assessed as fair for shareholders.

As a result of the offer, Morgan Stanley feels there may be wider industry consolidation and the valuation multiples of listed operators should respond favourably. Unsurprisingly, the company headed the table for largest percentage rise in target price by brokers in the FNArena database last week.

Sandfire Resources had the largest percentage fall in target price for the second week running, in an ongoing reaction to the acquisition of the MATSA underground copper mine and production plant project in Spain for $2.6bn. After raising its long term copper price forecast to US$9,000/t from US$7,500/t, Citi upgraded its rating to Buy from Neutral following a recent share price pullback.

Morgans believes any upside will likely be due to higher metals pricing, as well as operating improvements and life extensions, as the price paid for MATSA appears 'full-ish' (not foolish). Meanwhile, Ord Minnett sees strategic merit in the introduction of existing production from an OECD jurisdiction. Sandfire also headed up the list for the largest percentage fall in earnings estimates by brokers in the FNArena database last week.

Coming second was Mineral Resources as Morgan Stanley retains its aversion to low-grade iron ore producers and keeps its Underweight rating. The broker feels there are limited reasons for a bounce in iron ore demand and price, especially as the fourth quarter typically sees limited weather impacts upon supply.

a2 Milk Co was next, despite some relatively upbeat commentary by Citi suggesting potentially improving prospects for top-line growth after its major manufacturer, Synlait Milk guided to volume growth of 30-40% for infant formula in FY22. Any residual concerns should be overshadowed by improving trading conditions over the next nine months, in the broker's view.

Initiation of coverage of St Barbara by Ord Minnett with a Hold rating had the effect of lowering average forecast earnings in the database, when also taking into account forecasts from the other existing four brokers. The broker sets a target price of $1.50 and points out gold equities have underperformed the broader market year-to-date by around -46%, and notes renewed investor interest on rising inflation risks.

On the flipside, Western Areas had the largest percentage increase in forecast earnings by brokers last week as a Morgan Stanley lifted its FY22-24 EPS forecasts after revising up nickel price forecasts.

Those same increased forecasts for nickel, along with increases to forecast prices for spodumene and lithium hydroxide, helped lift the broker's earnings estimates for Orocobre. Morgan Stanley also updated its model for the merger with Galaxy Resources. Whitehaven Coal's FY22-24 EPS forecasts also benefited from the broker's forecast increases to thermal and metallurgical coal prices.

While upgrades across most of South32's commodities by Morgan Stanley also lifted the broker's EPS forecasts, the main kicker came from an agreement to acquire an additional 25% of the Mozal aluminium smelter in Mozambique for $250m. In combination with the recently announced restart of the Alumar smelter in Brazil, Credit Suisse estimates a 33% increase in aluminium output to 1.3mtpa.

Despite this, Morgans lowered its rating to Hold from Add, following a 27% share price rally since mid-August on rising coal and aluminium prices. The analyst feels aluminium, coking coal, and thermal coal prices are trading ahead of long-term sustainable prices.

Total Buy recommendations take up 54.11% of the total, versus 38.17% on Neutral/Hold, while Sell ratings account for the remaining 7.72%.

Upgrade

COLLINS FOODS LIMITED ((CKF)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 1/2/0

From industry feedback Macquarie deduces the recovery in the quick service restaurant market is improving and, moreover, Collins Foods is gaining share.

Growth in earnings will be supported by a consistent rolling out of stores. Meanwhile, online traffic was up 3.4% on the prior year to date.

Macquarie highlights category data that suggests chicken and Mexican-style fast food is growing faster than pizza, which augurs well for the company's KFC and Taco Bell brands. Rating is upgraded to Outperform from Neutral and the target raised to $12.50 from $11.15.

COCHLEAR LIMITED ((COH)) Upgrade to Neutral from Sell by Citi .B/H/S: 1/5/0

Citi has upgraded Cochlear to Neutral from Sell post a -15% fall in the share price, marking a -13% underperformance vis-a-vis the ASX200 over the past quarter.

The broker's DCF-derived price target remains unchanged at $220.

EVOLUTION MINING LIMITED ((EVN)) Upgrade to Equal-weight from Underweight by Morgan Stanley .B/H/S: 2/3/1

Morgan Stanley increases gold price forecasts (slightly) and thus FY22-24 estimates for earnings per share. Evolution Mining has some shorter life mines but the broker finds there is exploration and expansion upside potential at multiple sites.

The broker changes analysts and, with the stock trading around its new price target, upgrades to Equal-weight from Underweight. Target is reduced to $3.70 from $3.90. Industry view: In-Line.

INSURANCE AUSTRALIA GROUP LIMITED ((IAG)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 6/1/0

Macquarie believes the reaction to the Victorian earthquake has been overdone and, after allowing for quota shares, the company's maximum event retention of $169m is not expected to be breached.

The broker forecasts Insurance Australia Group is over provisioned by $400m for business interruption claims.

Macquarie assesses the stock is at an attractive discount of around -10-17%, depending on the valuation metrics, and upgrades to Outperform from Neutral. Target is raised to $5.70 from $5.40.

JB HI-FI LIMITED ((JBH)) Upgrade to Buy from Neutral by Citi .B/H/S: 2/3/1

Citi upgrades JB Hi-Fi to Buy from Neutral due to recent share price underperformance. While the analyst makes no changes to forecast earnings, the target price falls to $53 from $55 on changes to peer valuations.

The broker highlights a -40% discount to the ASX200 ex-resources index, while the stock usually trades between a -10% and -30% discount to the broader market.

ORICA LIMITED ((ORI)) Upgrade to Add from Hold by Morgans .B/H/S: 3/4/0

Prior to FY21 results on November 11, Orica has announced -$345-370m of after tax one-off items, which will now result in a statutory loss. Despite this, Morgans notes a strong balance sheet, improving operating conditions and an undemanding PE multiple.

As a result, the broker raises its rating to Add from Hold and edges up its target price to $13.70 from $13.65. The analyst highlights the new SaaS accounting standard will increase underlying earnings (EBIT) in FY21 by $20m, the equivalent of a 5% upgrade.

Morgans feels the earnings downgrade cycle of the last few years is now finally over.

SANDFIRE RESOURCES LIMITED ((SFR)) Upgrade to Buy from Neutral by Citi .B/H/S: 3/2/0

Citi upgrades to Buy from Neutral following a recent share price pullback. The analyst awaits better visibility on the announced -US$1.87bn acquisition of Spanish copper company MATSA, for a further potential re-rate opportunity.

The broker also raises its long term copper price to US$9,000/t from US$7,500/t. The target price rises to $7.30 from $6.82

Downgrade

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

Ord Minnett downgrades its rating to Accumulate from Buy after a recent share price rally. The target price is increased to $25.78 from $21.98 after raising the earnings forecast for FY22 to the midpoint of the group's underlying net profit guidance range of $70-73m.

Over the last few months, the analyst highlights the group has seen strong underlying EPS growth and consistent dividend growth, with the operating environment expected to remain favourable.

SOUTH32 LIMITED ((S32)) Downgrade to Hold from Add by Morgans .B/H/S: 6/1/0

Following a 27% share price rally since mid-August on rising coal and aluminium prices, Morgans lowers its rating to Hold from Add on valuation grounds. The target price rises to $3.65 from $3.30.

The company announced it has used its pre-emptive right to acquire an 25% interest in the Mozal operations, (aluminium smelter in Mozambique), for -US$250m. This will raise its stake to 72.1% from 47%.

The analyst feels aluminium, coking coal, and thermal coal prices are trading ahead of long-term sustainable prices.

SMARTGROUP CORPORATION LIMITED ((SIQ)) Downgrade to Hold from Add by Morgans and Downgrade to Neutral from Outperform by Credit Suisse and Downgrade to Accumulate from Buy by Ord Minnett.B/H/S: 1/4/0

Morgans moves to a Hold rating from Add after SmartGroup Corp received a non-binding indicative offer from US private equity firm TPG Global and Potentia Capital (consortium) for $10.35 in cash. The target price rises to the $10.35 bid price from $8.35.

The broker feels the likelihood of the offer being withdrawn is lessened by the company's resilient earnings base, clean balance sheet and recently renewed long-term contracts.

The Board, which intends to unanimously recommend the offer, has granted four weeks exclusive due diligence.

Credit Suisse increases its target price to $10.35 from $8 and lowers its rating to Neutral from Outperform after SmartGroup Corp received a proposal to acquire 100% of its shares for $10.35 by way of a Scheme of Arrangement.

The indicative, non-binding and conditional proposal is from a consortium comprising TPG Global and Potentia Capital. While competing offers could potentially emerge, the broker considers the price offered is good for shareholders.

Ord Minnett considers the $10.35 offer a strong price, without being exceptional, after SmartGroup Corp received an indicative proposal for acquisition by private equity.

While it is more likely than not the proposal will proceed, the broker downgrades its rating to Accumulate from

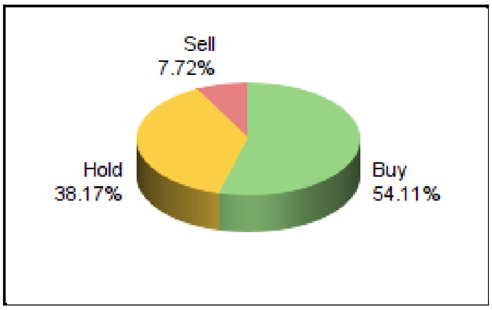
Buy, given the jump in the share price. The revised target price is $9.85 from $8.

VITA GROUP LIMITED ((VTG)) Downgrade to Hold from Buy by Ord Minnett .B/H/S: 0/1/0

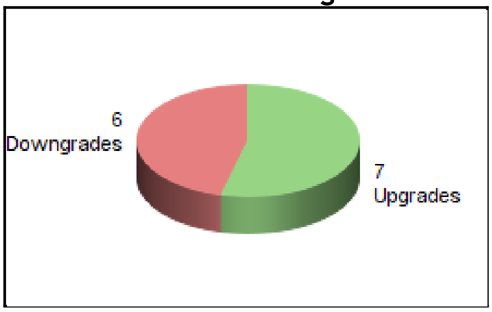
Ord Minnett lowers its rating to Hold from Speculative Buy. The broker's bear case scenario was realised after the sale of the ICT business at a favourable price to Telstra ((TLS)) of $110m or $0.66 cents per Vita Group share. The price target falls to $0.93 from $1.11.

Management intends to pay a special dividend of $0.39-$0.45cps out of the proceeds, with attached franking credits of $0.17-$0.19cps. The group will retain around $35m to support the growth of the Artisan skin health and wellness business and pay transaction costs.

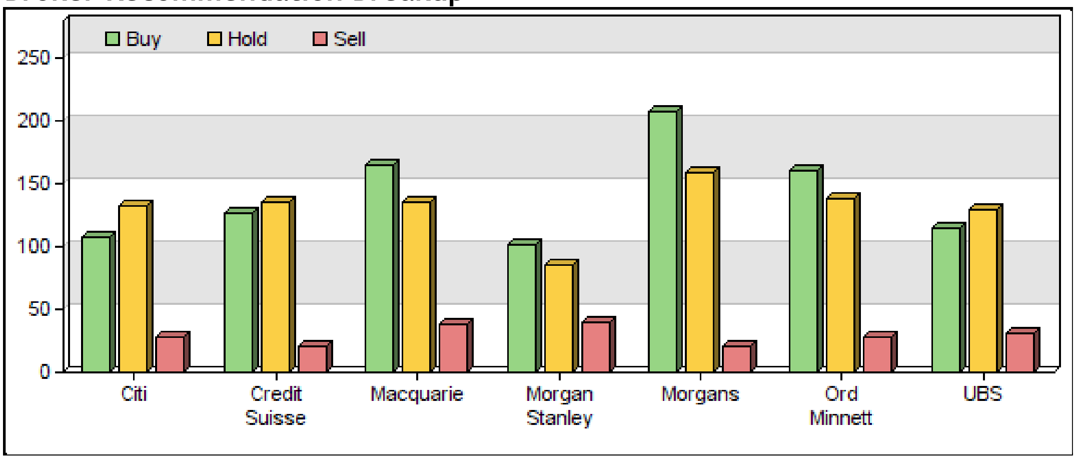
Total Recommendations



Recommendation Changes



Broker Recommendation Breakup



Broker Rating

Order	Company	New Rating	Old Rating	Broker
Upgrade				
1	COCHLEAR LIMITED	Neutral	Sell	Citi
2	COLLINS FOODS LIMITED	Buy	Neutral	Macquarie
3	EVOLUTION MINING LIMITED	Neutral	Sell	Morgan Stanley
4	INSURANCE AUSTRALIA GROUP LIMITED	Buy	Neutral	Macquarie
5	JB HI-FI LIMITED	Buy	Neutral	Citi
6	ORICA LIMITED	Buy	Neutral	Morgans
7	SANDFIRE RESOURCES LIMITED	Buy	Neutral	Citi
Downgrade				
8	AUB GROUP LIMITED	Buy	Buy	Ord Minnett
9	SMARTGROUP CORPORATION LIMITED	Neutral	Buy	Morgans
10	SMARTGROUP CORPORATION LIMITED	Neutral	Buy	Credit Suisse
11	SMARTGROUP CORPORATION LIMITED	Buy	Buy	Ord Minnett
12	SOUTH32 LIMITED	Neutral	Buy	Morgans
13	VITA GROUP LIMITED	Neutral	Buy	Ord Minnett

Recommendation

Positive Change Covered by > 2 Brokers

Order	Symbol	Company	New Rating	Previous Rating	Change	Recs

1	EVN	EVOLUTION MINING LIMITED	8.0%	-17.0%	25.0%	6
2	SLR	SILVER LAKE RESOURCES LIMITED	67.0%	50.0%	17.0%	3
3	IAG	INSURANCE AUSTRALIA GROUP LIMITED	79.0%	64.0%	15.0%	7
4	ORI	ORICA LIMITED	43.0%	29.0%	14.0%	7
5	HVN	HARVEY NORMAN HOLDINGS LIMITED	80.0%	67.0%	13.0%	5
6	WOW	WOOLWORTHS GROUP LIMITED	-7.0%	-17.0%	10.0%	7
7	VEA	VIVA ENERGY GROUP LIMITED	100.0%	92.0%	8.0%	5
8	A2M	A2 MILK COMPANY LIMITED	20.0%	17.0%	3.0%	5

Negative Change Covered by > 2 Brokers

Order	Symbol	Company	New Rating	Previous Rating	Change	Recs
1	SIQ	SMARTGROUP CORPORATION LIMITED	10.0%	60.0%	-50.0%	5
2	FPH	FISHER & PAYKEL HEALTHCARE CORPORATION LIMITED	-50.0%	-25.0%	-25.0%	4
3	TAH	TABCORP HOLDINGS LIMITED	60.0%	80.0%	-20.0%	5
4	AUB	AUB GROUP LIMITED	83.0%	100.0%	-17.0%	3
5	PTM	PLATINUM ASSET MANAGEMENT LIMITED	-75.0%	-60.0%	-15.0%	4
6	S32	SOUTH32 LIMITED	86.0%	100.0%	-14.0%	7
7	RMS	RAMELIUS RESOURCES LIMITED	88.0%	100.0%	-12.0%	4
8	NSR	NATIONAL STORAGE REIT	-33.0%	-25.0%	-8.0%	3
9	SFR	SANDFIRE RESOURCES LIMITED	60.0%	67.0%	-7.0%	5
10	SEK	SEEK LIMITED	60.0%	67.0%	-7.0%	5

Target Price

Positive Change Covered by > 2 Brokers

Order	Symbol	Company	New Target	Previous Target	Change	Recs
1	SIQ	SMARTGROUP CORPORATION LIMITED	9.250	7.750	19.35%	5
2	SEK	SEEK LIMITED	33.528	31.440	6.64%	5
3	S32	SOUTH32 LIMITED	3.950	3.707	6.56%	7
4	AUB	AUB GROUP LIMITED	25.667	24.400	5.19%	3
5	WOW	WOOLWORTHS GROUP LIMITED	39.003	38.003	2.63%	7
6	NSR	NATIONAL STORAGE REIT	2.177	2.128	2.30%	3
7	HVN	HARVEY NORMAN HOLDINGS LIMITED	6.290	6.158	2.14%	5
8	VEA	VIVA ENERGY GROUP LIMITED	2.460	2.433	1.11%	5
9	MTS	METCASH LIMITED	4.300	4.260	0.94%	6
10	IAG	INSURANCE AUSTRALIA GROUP LIMITED	5.543	5.500	0.78%	7

Negative Change Covered by > 2 Brokers

Order	Symbol	Company	New Target	Previous Target	Change	Recs
1	SFR	SANDFIRE RESOURCES LIMITED	6.630	7.827	-15.29%	5
2	EVN	EVOLUTION MINING LIMITED	4.110	4.225	-2.72%	6
3	PTM	PLATINUM ASSET MANAGEMENT LIMITED	3.850	3.920	-1.79%	4

Earning Forecast

Positive Change Covered by > 2 Brokers

Order	Symbol	Company	New EF	Previous EF	Change	Recs
1	WSA	WESTERN AREAS LIMITED	5.508	3.175	73.48%	5
2	ORE	OROCOBRE LIMITED	18.207	11.560	57.50%	5
3	S32	SOUTH32 LIMITED	41.438	31.495	31.57%	7
4	WHC	WHITEHAVEN COAL LIMITED	58.862	47.028	25.16%	6
5	VEA	VIVA ENERGY GROUP LIMITED	13.548	11.290	20.00%	5
6	IGO	IGO LIMITED	33.380	28.630	16.59%	4
7	AWC	ALUMINA LIMITED	8.173	7.380	10.75%	5
8	HLS	HEALIUS LIMITED	34.565	31.332	10.32%	6
9	SDF	STEADFAST GROUP LIMITED	19.925	19.140	4.10%	4
10	ORI	ORICA LIMITED	49.979	48.010	4.10%	7

Negative Change Covered by > 2 Brokers

Order	Symbol	Company	New EF	Previous EF	Change	Recs
1	SFR	SANDFIRE RESOURCES LIMITED	85.013	118.317	-28.15%	5
2	MIN	MINERAL RESOURCES LIMITED	518.333	689.667	-24.84%	4
3	A2M	A2 MILK COMPANY LIMITED	15.698	19.941	-21.28%	5
4	SBM	ST. BARBARA LIMITED	3.750	4.600	-18.48%	5
5	PMV	PREMIER INVESTMENTS LIMITED	131.150	159.950	-18.01%	6
6	SXY	SENEX ENERGY LIMITED	17.480	20.240	-13.64%	5
7	BKW	BRICKWORKS LIMITED	132.840	149.480	-11.13%	5
8	TCL	TRANSURBAN GROUP LIMITED	9.490	10.319	-8.03%	5
9	NWS	NEWS CORPORATION	90.256	96.618	-6.58%	4
10	RIO	RIO TINTO LIMITED	1883.719	1965.195	-4.15%	7

Technical limitations

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

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WEEKLY REPORTS

Uranium Week: Term Contract Prices Soar

As the weekly spot uranium price has a second consecutive week of falls, prior increases have placed upward pressure on term contract prices.

-Material rises for both mid and long-term prices
-Vimy Resources secures mining approvals
-Uranium spot price falls over -6% for the week

By Mark Woodruff

Term contracting prices moved up strongly last week, potentially signalling the recent rise in spot prices may not be an aberration.

TradeTech's **mid-term** price indicator for September 30 closed at US$43.75/lb, a rise of US$8/lb, while the **long-term price indicator** increased by US$10/lb to close the month at US$45/lb.

Growing levels of spot purchases, by parties that intend to sequester the material, is placing pressure on the mid-and long-term uranium markets, points out TradeTech.

The August trend of spot uranium price rises outpacing prices in the mid-and long-term sectors was reversed in September. From the second half of the month spot prices began to fall.

Buyers came to the mid-and long-term markets through various channels, including formal Requests for Proposals (RFPs) and off-market discussions with potential suppliers. Five transactions were reported in the term uranium market for September.

Meanwhile, TradeTech's **Weekly Spot Price** Indicator last week fell by -US$2.85 lb or over -6% to US$41.25/lb. The Indicator has risen 60% above the 2021 low point of US$27.40/lb and is up 36% in 2021. The average Weekly Spot Price in 2021 is US$32.26/lb, US$2.55 above the 2020 average.

The -20% fall over the last two weeks has been driven partly by dual uncertainties pertaining to the Evergrande debt crisis in China on world equity markets and the progress of the US$1.2tr infrastructure bill in the the US House of Representatives, according to TradeTech. It’s felt the arrival of investor interests, such as the Sprott Physical Uranium Trust (SPUT), has amplified the sentiment-driven nature of the spot price and broadened its sensitivity to developments outside the nuclear industry.

Nonetheless, the fundamental factors that led to the creation of SPUT remain at play in the uranium market, notes TradeTech. These include the structural supply deficit and lack of term contracting to support new production.

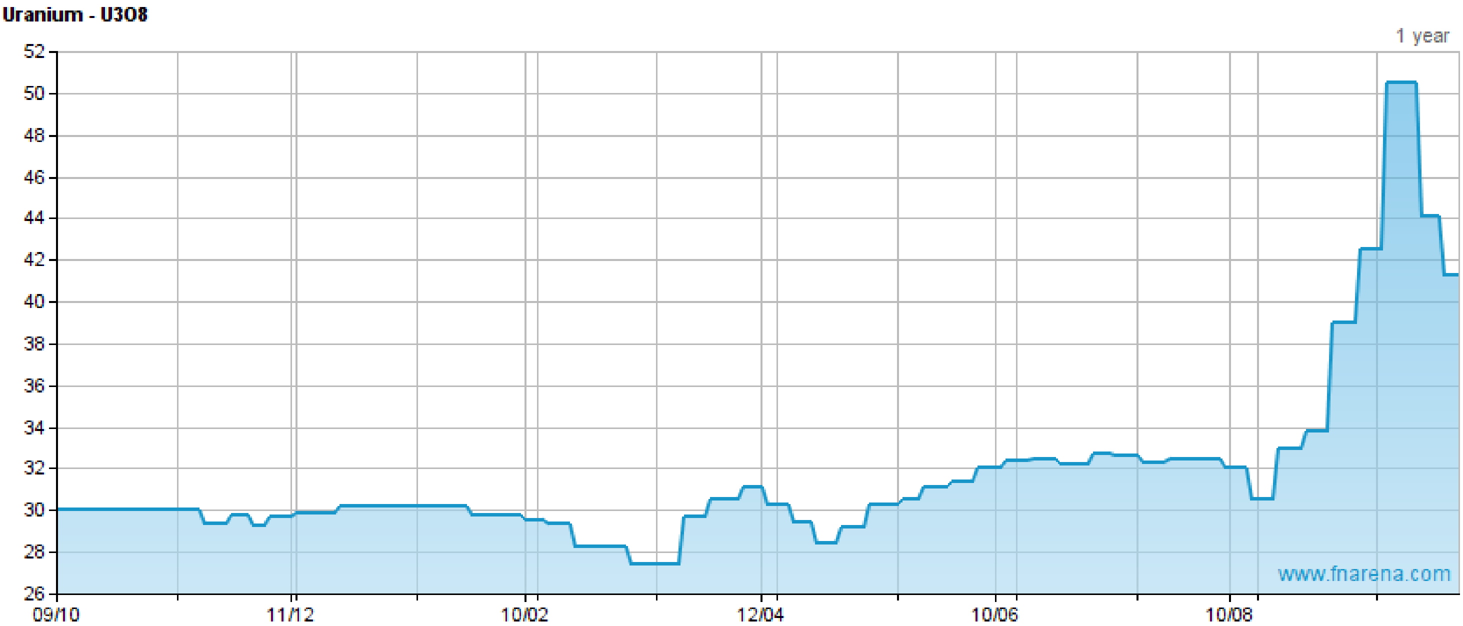
In the largest transaction volume total recorded in a single month in the uranium spot market since 1996, 14.5mlbs U3O8 equivalent were transacted in September.

TradeTech's **monthly spot price** increased by US$7.45/lb to close out September at US$42.20/lb, the highest level reached in over eight years. It has risen over 64% in the last 24 months.

<u>Company news</u>

The Mulga Rock project may be developed and operated now that ASX-listed **Vimy Resources** ((VMY)) has received approval for the Mulga Rock Mining Proposal and Mine Closure Plan.

Interim CEO Steven Michael noted “this allows Vimy to further de-risk the project....and continue on the path towards first production by 2025.”



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WEEKLY REPORTS

The Short Report - 07 Oct 2021

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

Summary:

By Greg Peel

Week Ending September 30, 2021.

Last week saw Wall Street throw a taper tantrum of sorts, before a dummy was quickly shoved in and order was restored ahead of this week's volatility. The ASX200 has been obediently following along.

Whatever was the reason behind Ansarada Group ((AND)) making a shock debut onto the 5%-plus shorted table the week before, at 13.4%, it matters not now, as the stock disappeared last week.

And while there is every reason to believe shorts in AGL Energy ((AGL)), which the week before sat at 7.1%, were a "naked" short ahead of the company's attempts to spin off its legacy coal-fired business, AGL also did a disappearing act last week.

This probably implies there was position on the other side of that short – long another stock or an options position for example – and the trade has now been closed out.

Otherwise, nothing else moved or shook last week in Short Land.

We might note, nonetheless, shorts in a2 Milk ((A2M)) dropped to 5.8% from 6.3% last week. Unfortunate timing perhaps, given a2 fell -7.7% yesterday on news of a shareholder class action.

Weekly short positions as a percentage of market cap:

10%+
FLT 10.2

Out: AND

9.0-9.9

KGN

Out: Z1P, EOS

8.0-8.9%

WEB, Z1P, MSB, EOS, ING, RBL

In: Z1P, EOS, RBL

7.0-7.9%

COE, TGR

Out: RBL, AGL

6.0-6.9%

AMA, MTS, TPW

Out: A2M

5.0-5.9%

A2M, BHP, PNV, OBL, BGL, RSG

In: A2M

Movers & Shakers

Nothing this week.

ASX20 Short Positions (%)

Code	Last Week	Week Before	Code	Last Week	Week Before
ALL	0.0	0.0	MQG	0.2	0.2
ANZ	0.6	0.6	NAB	0.6	0.5
APT	1.1	1.1	NCM	0.1	0.1
BHP	5.8	5.7	RIO	0.3	0.3
BXB	0.4	0.6	TCL	0.7	0.5
CBA	0.5	0.4	TLS	0.2	0.2
COL	0.6	0.5	WBC	0.6	0.6
CSL	0.2	0.1	WES	0.2	0.2
FMG	1.7	1.6	WOW	0.2	0.2
GMG	0.1	0.1	WPL	1.6	1.6

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

Guide:

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

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

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

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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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WEEKLY REPORTS

The Wrap: Banks, Platforms, Media & Insurance

Impact of APRA upon banks and property; platform players; traditional media; and general insurance.

-The impact of APRA intervention upon banks and property
-AMP and IOOF Holdings preferred to Netwealth Group and Hub24
-Has Australian traditional media reached a turning point?
-Two Overweight-rated insurers

By Mark Woodruff

The impact of APRA intervention upon banks and property

APRA has increased the minimum interest rate buffer for banks to apply when assessing the serviceability of home loan applications. This comes after a rise in the share of heavily-indebted borrowers and increased household sector leverage.

The buffer will now be at least 3% above the loan product rate, which compares to the around 2.5% average buffer used formerly.

The regulator points out that on average, **investors borrow at higher levels of leverage and may have other existing debts. As a result, they are more likely to be impacted than owner-occupiers.** All in all, APRA expects the impact from these measures on aggregate housing credit growth to be "fairly modest".

Goldman Sachs agrees and remains positive on the banks, retaining its Buy rating for four of the six listed retail banks in National Australia Bank ((NAB)), ANZ Bank ((ANZ)) Westpac Bank ((WBC)) and Bank of Queensland ((BOQ)). The broker points out that **a 1% change in housing credit growth changes sector earnings by around 1%.**

Macquarie also agrees **there will be a modest impact on credit availability** from APRA's move, though cautions it may be enough to achieve its objective if it weakens confidence and moderates property price appreciation.

Given emerging margin pressures in FY22, the broker believes banks may await an opportune time to reprice mortgages and support short-term profits, though over time this approach could result in higher churn.

In the short term, Macquarie feels the sector may benefit from rising bond yields and reasonable relative valuations versus the market, while in the longer term there's considered limited sector appeal. National Bank is preferred while caution should be applied regarding the premium valuation afforded to Commonwealth Bank ((CBA)).

Meanwhile, JP Morgan agrees on the limited impact from APRA (despite the intervention coming earlier than expected) and had already factored in to forecasts a slowdown in bank loan growth for FY22/23. While Citi generally has the same view of the impact, it comes with a twist in that the change may actually represent a better-than-anticipated outcome in the short-term, given prior fears of a more draconian intervention.

Morgan Stanley leaves its forecast for the major banks' average housing loan growth unchanged and believes further measures will be required by APRA.

In looking at **the effect upon the property market,** the broker doesn't expect a large impact upon residential sales for Mirvac Group ((MGR)) or Stockland ((SGP)). In each case, their respective land projects are more aimed at the affordable product/owner occupier market. However, it's acknowledged that macroprudential measures may in time weigh upon house prices.

AMP and IOOF Holdings preferred to Netwealth Group and Hub24

Following material underperformance since the Financial Services Royal Commission, it may be time to revisit traditional wealth management/platform players like AMP Ltd ((AMP)) and IOOF Holdings ((IFL)).

The aggregate market value of these two companies is now close to being overtaken by that of leading specialty platform providers (SPP) Netwealth Group ((NWL)) and Hub24 ((HUB)). This is despite having only one quarter of the funds under administration (FUA). Moreover, they are currently trading at record multiples while facing moderating growth prospects. Taking all this into account, Jarden sets an Underweight rating for the two SPPs.

By contrast, the broker has a more upbeat stance on the traditional platform players, with a preference for IOOF Buy) over AMP (Neutral) on valuation grounds and lower execution risks. A more positive stance on AMP would arise should brand-related asset under management (AUM) retention issues ease. Also, the AMP Capital demerger would be viewed favourably if it proceeds without significant dis-synergies.

With further cost-out ahead for the traditional players, and both platform and advice revenues bottoming, the analyst can see growth in earnings supporting value upside off depressed multiples.

In terms of cost-out, the broker sees scope at IOOF for further platform consolidation beyond FY22 to add over $100m to profit, if it can reduce platform costs to 20 basis points or below. This would represent over 25% potential additional value upside. Similarly, it's estimated that for every -2bps cost reduction across AMP's Australian Wealth Management division, 5% is added to group profit forecasts.

Additionally, Jarden sees longer-term upside for the advice businesses of both companies, as falling advisor numbers leads to demand outstripping supply. An extra boost would arise if onerous regulatory requirements ease.

Perhaps the best summary of the above is achieved by **comparing relative 12-month forecast total shareholder returns**. The broker estimates no return for Hub24 and 1% for Netwealth, while forecasting 14% and 32% for AMP and IOOF, with the latter receiving a boost from an attractive dividend yield.

Has Australian traditional media reached a turning point?

Australian traditional media could have reached an inflexion point. On a three-year view, **the growth in**

broadcast video on demand (BVOD) may offset the ongoing structural pressures upon traditional linear broadcast TV.

UBS agrees with this assertion from management at Nine Entertainment ((NEC)), and forecasts BVOD growth of 40% in FY22. This implies 9.5% growth in the combined metro free-to-air (FTA) and BVOD markets.

Despite concerns over structural issues for metropolitan radio (the advertising market has not returned to pre-covid levels), the broker assumes 12% growth in radio advertising in FY22. This still implies the FY22 radio advertising market is -12% smaller than FY19.

Apart from expecting advertising market strength, UBS identifies **four other themes for traditional media companies**. These include continued earnings growth from digital, and growth from recently struck Facebook and Google deals. Moreover, the analyst anticipates a return of, or an increase in, dividends/capital management, along with potential for M&A. The final theme concerns escalating costs, as a result of cyclical factors.

News Corp ((NWS)) is one of the broker's preferred picks in the space and benefits from a few of the above themes, as well as speculation concerning a potential Foxtel IPO spin-off. Nine Entertainment is the other preferred pick and UBS lifts its target price by 24% to $3.85.

Meanwhile, the analyst materially increases the Seven West Media ((SWM)) price target to $0.90 from $0.65, due to the new advertising market outlook and a change in valuation method.

All three companies mentioned above have a Buy rating from UBS.

Two overweight-rated insurers, despite market share headwinds

Despite declining competition in the profitable Home and Personal Motor products space, Macquarie is disappointed in the market share of both Suncorp Group ((SUN)) and Insurance Australia Group ((IAG)).

In an ongoing trend, both insurers have ceded around -650bps of market share in aggregate since FY15. The broker expects this declining share to continue in the coming years, which should also impact upon QBE Insurance Group ((QBE)) and Allianz Insurance.

One takeaway from the broker's annual survey of 25 insurers shows customer retention will become an increasingly important metric as government support subsidies. Also, competitive market pressures are expected to step-up again in FY23.

Despite the competitive backdrop, Macquarie still likes **IAG (Outperform)** on a valuation basis. The group's customer retention also remains significantly better than that of **Suncorp (Outperform)**, which largely explains the margin and gross written premium (GWP) growth variance between the two insurers.

Even so, the analyst explains Suncorp has stronger earnings upside and a more robust gross written premium growth strategy, should customer retention soften across the market.

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SMALL CAPS

Nick Scali Settles On Plush Sofas

Nick Scali will acquire Plush, another made-to-order sofa retailer, providing the scope to target a broader consumer demographic

-Plush is regarded a highly complementary business, expected to deliver significant synergies to Nick Scali
-Margin differences expected to narrow as synergies are obtained
-Nick Scali plans to keep both brands separate

By Eva Brocklehurst

Nick Scali ((NCK)) has settled on Plush-Think Sofas to expand its business to the couch potatoes of Australasia. The business has been acquired for $110m and will be funded through cash and new debt.

What is Plush? Plush is a specialist sofa retailer with 46 showrooms, positioned in the mid-range made-to-order market. Categories include modular lounges, chairs, recliners, ottomans and sofa beds. The model is similar to Nick Scali's in terms of the supply chain and category mix.

Macquarie observes this is a highly complementary business to the more upmarket brand of Nick Scali and a dual brand strategy should be able to target a broader customer demographic.

Nick Scali expects the transaction will be accretive to earnings in the first full year of ownership and before synergies, which were not disclosed. A two-year integration period is anticipated before material synergies should flow and Citi assumes -$5m in integration costs, likely to reflect redundancies.

Jarden agrees there is a strong strategic rationale given a complementary brand, scope to grow and both purchasing and cost synergies, estimating the deal will be 5% accretive in FY22 and 18% accretive in FY23.

The broker continues to expect **the sales boost resulting from the pandemic will wane** and rotation to travel/services from discretionary goods occur. This previously led to an Underweight rating for Nick Scali. Yet the macro environment remains favourable and this acquisition compelling so Jarden upgrades to Neutral with a target of $12.40.

Citi reiterates a Buy rating, raising the target to $16.80, and asserts, prior to the acquisition, consensus had been factoring in a -25% decline in earnings per share for Nick Scali, despite a strong housing cycle and FY22 order book.

The broker expects Nick Scali will move to a net debt position by the end of FY22 as it uses cash and raises new debt to fund the acquisition, and assumes $50m in new debt is raised and the remainder funded with cash.

Margins

In FY21 Plush generated $160m in revenue and $27m in underlying operating earnings (EBITDA). Macquarie notes an underlying EBITDA margin of 17% in FY21 compared with Nick Scali at 34%.

Jarden estimates gross margins for Plush of around 53%, higher than the industry average of 50%, because of its import mix. Through procurement benefits this should then grow around 200 basis points to 55% over the two-year integration period.

The broker also estimates the cost of doing business (CODB) margin is structurally lower than that of the core business of Nick Scali, primarily because of the volume/pricing difference. Acknowledging some assumptions, Jarden suspects Nick Scali's gross margin will decline by around -270 basis points because of the inclusion of Plush, and then improve from FY23-25 as synergies are obtained.

Citi acknowledges Plush has lower sales per store and margins compared with Nick Scali but highlights the opportunity to significantly increase overall scale that will in turn generate supply and cost synergies.

Moreover, Nick Scali is considered better placed to negotiate rents, given the leverage from the owned part of its property portfolio, and while the overlap in terms of suppliers is limited, the company can leverage established relationships with China and Vietnam to reduce sourcing costs for Plush.

Cannibalisation?

Citi's analysis shows around 68% of Nick Scali stores have a Plush store located within 5km, likely a function of large format retail sites where home contents retailers are typically located. Despite the overlap, Nick Scali plans to keep both brands separate.

There will now be 108 showrooms across Australasia with opportunities for new stores as well. **Nick Scali expects to be able to open new Plush stores in areas which are under represented.**

Plush has a long-term target of 90-100 stores in addition to Nick Scali's target of at least 85 stores from the current 62. Citi notes Plush stores are typically half the size of Nick Scali stores and hence there appears to be significantly more roll-out opportunity for the former.

Currently Plush has no stores in New Zealand which could be an expansion opportunity, the broker adds, given Nick Scali has successfully expanded its presence there.

SMALL CAPS

Confidence In Baby Bunting Grows

While store sales of baby goods may have been hindered by lockdowns, Baby Bunting's update has underscored confidence in the outlook

-Margins benefitting from increased private-label/exclusive product sales
-Total sales growth impacted by shopping centre locations
-Baby Bunting in strong position versus smaller competitors

By Eva Brocklehurst

An AGM update from Baby Bunting ((BBN)) provided much-anticipated confirmation that sales momentum should pick up as NSW, Victoria and ACT shed their combined lockdown status. Total sales growth over the year to date was a modest 1.5%, yet after comparable store sales growth in the first seven weeks of the first half declined -6.4% the following seven weeks increased 3.2%.

The clincher is, taking out NSW and ACT, comparable store sales have increased 10% since August. What is more clear-cut is that online sales have increased 37.7%, despite cycling strong growth in the prior corresponding period.

Citi expects like-for-like sales growth to improve to 9% over the remaining 12 weeks of the first half, as NSW, Victoria and ACT stores benefit from pent-up demand following the lifting of restrictions.

In the second half the rate of growth may be slower, the broker advises, as freight costs remain elevated. Citi now expects a gross margin of 38.6% because private-label/exclusive product sales continue to grow. Gross margins are currently 38.7% and have benefited from an increase in private-label and exclusive products and these now represent 44.3% of total sales.

Supply chain issues are not complicating things either, with availability currently sitting on more than 95% amid limited shortages.

Shipping costs may be elevated yet Baby Bunting has managed to contract rates to the end of the first half and limited price increases by leveraging efficiencies from the recent investment in the supply chain.

Morgans notes some inflation in the cost of goods sold because of higher freight rates and sourcing challenges but points out the company has no reliance on airfreight. Still, this dynamic provides **reason to be somewhat cautious about margins as the year progresses.**

As a result of the AGM update, Ord Minnett is confident its investment thesis is intact while the update also delivered on Morgan Stanley's expectations. The latter considers Baby Bunting one of the highest quality small cap retailers in the country, firmly holding its position in an attractive non-discretionary category.

Morgan Stanley reiterates an Overweight rating and Citi does so too, with a Buy rating, assessing the company has a range of multi-year growth strategies. The exclusive/private-label roll-out is progressing faster than previously anticipated, resulting in gross margins that were also better than expected.

Negatives?

Was there a negative? Despite like-for-like momentum improving, total sales growth was soft. Citi explains this is likely to be because three out of the four new stores that opened in FY21 were located in shopping centres, and these have been more adversely affected by reduced foot traffic compared with the large format retail venues.

Regardless, Baby Bunting has a dominant market position and combined with investment in inventory the broker believes it is in a better position compared with its smaller competitors.

Expansion Potential

Morgans upgrades to Add, given the sales and margin trends. The broker concludes, as the only nationwide specialty retailer of maternity and baby goods, Baby Bunting can take market share from non-specialist competitors such as department stores, and also build a strong presence online, highlighting Baby Bunting has less than 20% of a $2.5bn addressable domestic market.

New Zealand represents another growth driver with new stores opening later in 2021 and, Morgans suggests, could provide a template for further geographic expansion in the future. Still, entering a new market brings risk and the broker will be following sales data from New Zealand closely.

Macquarie is also on board, retaining an Outperform rating and suggesting sales and margin trends, as well as the store rollout, support the outlook.

FNArena's database has six Buy ratings for Baby Bunting. The consensus target is $6.39 which suggests 12.8% upside to the last share price.

See also, Baby Bunting To Bounce? On August 17, 2021.

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