Week

25

Stories To Read From FNArena

Friday, 21 June 2019

FNArena
Financial News, Data & Analysis

GPO Box 3145
Sydney NSW 2001

info@fnarena.com

Your editor
Rudi Filapek-Vandyck

Your dedicated team of journo's
Greg Peel
Eva Brocklehurst

© News Network 2019. All Rights Reserved. No portion of this website may be reproduced, copied or in any way re-used without written permission from News Network. All subscribers should read our terms and conditions.

Contents

Australia

1 Aussie Disconnected From Commodity Prices
2 Ramp-Up Delay Hinders Pilbara Minerals
3 Buybacks Underpin BlueScope Steel
4 Link Administration Highlights Expansion
5 CYBG Plans To Be In The Money With Virgin

Commodities

6 Thucydides Trap And Gold
7 Thermal Coal Glut: Who Will Blink First?
8 Material Matters: Copper, Steel & Manganese

ESG Focus

9 ESG Focus: Plastic - Not So Fantastic But Pretty Elastic (Part 2)

FYI

10 Weekly Ratings, Targets, Forecast Changes
11 Uranium Week: Restart Setback
12 The Short Report
13 The Wrap: Wealth, A-REITs And Yield Stocks

Small Caps

14 Sale Puts Focus On Senex Energy's Gas Output
15 Tight Rental Market Enhances Emeco Holdings

Treasure Chest

16 Treasure Chest: A Taste Of Freedom

Weekly Analysis

17 A Confirmation From Aussie Banks
18 Rudi's View: Banks, Bapcor, And Woolworths

Aussie Disconnected From Commodity Prices

ANZ Bank economists note the Aussie dollar is no longer being supported by commodity prices as has typically been the case.

-Iron ore up, Aussie down -Mining profits up, economy weak -Chinese stimulus no longer supportive

By Greg Peel

The Australian dollar has long been considered a “commodity currency” given Australia’s major exports, and thus source of income, are minerals, metals and gas. But as the Aussie slides below US70c at a time iron ore prices have shot up over US$100/t, ANZ Bank economists suggest that at least for now, that connection no longer holds true.

Typically, stronger commodity prices incentivise greater mining investment and lead to increased mining profits, which then flow through to increased tax collections for the government.

Greater mining investment means more jobs, increased profits mean greater returns for investors who can then spend that money, driving economic growth, and increased tax collections allow for increased government spending, also driving economic growth.

More jobs and profits lead to wage & price inflation, and between stronger growth and rising inflation the RBA is forced to raise interest rates. Before this flow-through occurs, the Aussie will have already risen in anticipation.

But the RBA has just cut its cash rate to a new historic low with more cuts expected and the Aussie continues to fall.

The reasons behind this disconnect are several, ANZ Bank economists suggest.

Firstly, as the last of the big LNG plants complete construction, the mining investment boom enjoyed by Australia over the past decade is coming to a close. While miners are making solid profits there is little incentive to invest in further growth. We’ve seen the growth phase, now we’re in the production phase.

Instead of investing in further growth, miners are returning most of their profits to shareholders via dividends. While such money in the pocket should lead to increased consumer spending, the reality is 50% of Australian stock market investment is held in super funds, which is money that can’t yet be spent.

The government may well be enjoying greater tax receipts from the miners, except a lot of recently constructed mining (and gas) projects are foreign-owned. And the government is hell bent on returning the budget to surplus, which keeps a lid on government spending.

As the recent federal election result highlighted, a lot of mining jobs have been lost since the investment phase gave way to the production phase which has led to high unemployment and electorate desperation in, particularly, northern Queensland. The RBA is now fixated on lowering the unemployment rate from over 5% to 4.5% in order to lift wage growth and thus inflation, hence the recent rate cut.

ANZ Bank is not alone in believing this is a tough ask, even if the RBA cuts three times all up, the government delivers its tax cuts and the Aussie falls to US65c.

While the iron ore price initially shot up this year due to Brazilian export suspensions, more generally commodity prices are determined by demand from Australia’s biggest trading partner – China. When the Chinese government decides to implement economic stimulus, which typically includes investment in infrastructure, a subsequent increase in commodity demand pushes up prices.

In other words, the Aussie should go up every time Beijing ups the stimulus ante. But that’s what’s happening now, and there’s talk of more to come, yet the Aussie has slipped under US70c for the first time since the GFC.

With this direct correlation now broken, ANZ Bank suggests increased Chinese stimulus can still provide for flow-through improvement in the Australian economy if it drives an increase in risk appetite. But on that front we have to look at why Beijing sees the need for stimulus. The Chinese economy is slowing.

Indeed, the global economy is slowing. It is not a time of increased risk appetite.

Of course, a lower Aussie is a matter of swings and roundabouts for the Australian economy. Once upon a time an Aussie in the mid-to-high sixties was considered “just right”. Exporters benefit from a lower exchange rate – not just in the resource sectors, but in the likes of tourism and the burgeoning foreign education sector.

On the flipside, not a lot of products are manufactured in Australia any more. Not even cars. And there is more and more imported food on supermarket shelves. Consumers are the losers at the checkout when the exchange rate falls.

So it’s a balance. And arguably one of the primary reasons the Australian stock market has well-underperformed Wall Street post-GFC is because the Aussie ran up from its GFC low to over parity with the US dollar in 2012, and taken this long to come back down again.

That had the RBA very frustrated at the time. While the central bank is hardly without its worries at present, the fact higher commodity prices (iron ore in particular) are not ultimately leading to a stronger currency at this time must be a blessed relief when monetary policy capacity is swiftly running out.

Which is not an issue for the Fed. The US central bank is widely tipped to cut rates soon which, ceteris paribus, should lead to a weaker US dollar and thus a stronger Aussie dollar. UBS economists, who agree with ANZ Bank's assessment of the Aussie disconnect with commodity prices, suggest in a world bracing for a trade war and resultant further slowing in global growth, the Aussie is not likely to find such support.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

FNArena is proud about its track record and past achievements: Ten Years On

Ramp-Up Delay Hinders Pilbara Minerals

Pilbara Minerals is reducing its output of lithium from Pilgangoora to meet the requirements of its offtake partners as its refinery ramp-up is behind schedule.

-Broader market weakness as recently commissioned supply outpaces demand -Poor market sentiment may reduce the value the company can realise from renegotiated contracts or a partial sell-down -Demand still expected to build and a period of constrained supply should support lithium prices

By Eva Brocklehurst

Delayed commissioning and ramp up of a customer's conversion facilities has caused Pilbara Minerals ((PLS)) to re-evaluate its scheduling. The company is moderating its output from Pilgangoora up until the end of July and will use the period to accelerated its plant defect rectification program.

Refinery ramp-up is behind schedule, reflecting technical complexity rather than weak demand for high-purity lithium chemicals, Canaccord Genuity suggests. The company asserts spodumene offtake is slow because of a conversion capacity mismatch, rather than customers refusing to take more feedstock.

Negatives are principally market-driven, Credit Suisse asserts, believing the shortfall in sales volumes is indicative of broader market weakness as recently-commissioned supply is outpacing the rate at which demand is developing. Still, Pilbara Minerals is not alone. Across the lithium spectrum, the broker observes realised sales have fallen short of production and the spot market is insufficiently developed to take up the excess.

Given the softening outlook for prices, Canaccord Genuity suspects the company will be reluctant to place additional sales into the spot market. Citi cautions that weaker pricing for lithium chemicals could reduce the converters' appetite for expansion, nonetheless.

Pilbara Minerals has noted that 6% spodumene product now trades for between US$600-640/dmt. Pilgangoora produced 22,400dmt, or around 85% of nameplate, of spodumene concentrate during May, a site record. The company is assessing the diversification of its stage 1 sales to other parties, potentially to a stage 2 partner, Great Wall Motors, which has an interest in the new 25,000t lithium plant in Guanxi.

Pilbara Minerals has been engaged with industry participants rather than offtake partners with the aim of growing sales volumes, although remains confident current offtake partners will meet commitments once the plant conversion advances.

Outlook

Canaccord Genuity expects operations will break even over the June quarter. The company has guided to production of around 65,000t and 23-45,000t in sales in the quarter, a soft result given around 14,000t was shipped early. Macquarie assumes the company will ship at the top end of its guidance range with a similar level of production and shipments in the September quarter.

Pilbara Minerals has looked to sweeten its offer for a project sell-down of up to 49% by offering existing offtake that could be freed up under renegotiated contracts. While there is clear merit in partnering in a downstream strategy, Canaccord Genuity believes poor market sentiment could reduce the value the company can realise.

The broker does not expect the company will deal on stage 3 in the near term and because of this uncertainty has removed stage 3 from an assumed project development path. Canaccord Genuity, not one of the eight stockbrokers monitored daily on the FNArena database, has a Hold rating and $0.60 target.

The company expects a final investment decision on the proposed POSCO joint venture for the downstream conversion facility in South Korea in the September quarter, a potential catalyst in Citi's view.

Value

Credit Suisse remains firmly of the view that the high-quality and readily expandable Pilgangoora asset will mean it gets to be one of the leading global spodumene suppliers. Moreover, there is potential for the minority sale process to crystallise value in the September quarter above the traded equity value.

While maintaining a positive investment view, the broker acknowledges current market dynamics put its Outperform rating at risk for the near term. Nevertheless, there is opportunity for Pilbara Minerals to re-rate as it concludes its strategic partnering and sale process.

The company has indicated a high level of strategic interest from multiple parties that are conducting due diligence. While asset buyers are taking longer-term views versus the equity market, Credit Suisse assesses a sale process under a softening sales environment is unlikely to extract maximum value. Nevertheless it still offers compelling upside versus trading levels.

The broker also notes that recently commissioned supply has come from sanctioned and funded projects. There remains a dearth of financing for lithium juniors, which were poised to provide the next leg of supply to the market. As demand builds, the broker expects there will be a period of constrained supply and that will support lithium prices and, in line, lithium equity values. However, the prospect of when the market will turn is unclear.

FNArena's database shows two Buy ratings and one Sell (Ord Minnett, yet to comment on the update) for Pilbara Minerals. The consensus target is $0.90, signalling 47.5% upside to the last share price.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

FNArena is proud about its track record and past achievements: Ten Years On

Buybacks Underpin BlueScope Steel

BlueScope Steel provided a disappointing update for the market, downgrading earnings guidance amid soft building product volumes in both Australia and North America.

-Late cycle nature of the company's building products could have a delayed impact -Concerns about sanctioning of North Star expansion as steel spreads are below viable levels -Further $250m in buybacks announced for first half FY20

By Eva Brocklehurst

BlueScope Steel ((BSL)) has provided the downgrade many brokers were expecting after they assessed the narrowing of steel spreads in the wake of recent US tariff increases. However, the market is also disappointed with the update on building products, amid soft volumes in both Australia and North America.

The downgrade to guidance implies a -9% reduction to second half earnings (EBIT). The company is expecting earnings growth of 6% in FY19 versus 10% previously, and guiding to EBIT of $1.35bn. UBS was not surprised, given the known weakness in steel spreads (gap between the buying and selling price of steel). The broker's second half spread estimate is lowered by -US$20/t to US$374/t.

The company has also pointed to softer than expected conditions in Asia and North America and weaker margins in volumes in buildings in North America. Building products in North America have been affected by longer customer lead times.

Australia is performing in line with initial expectations, as pricing has been better than expected and has offset weak demand. However, the company did not discuss this in detail, which leads Ord Minnett to be cautious, suspecting BlueScope Steel could be foreshadowing some impact in FY20 from is shifting sales mix.

The company has signalled to date that it is insulated from declines in home construction, given exposure to alterations & additions and with limited exposure to multi-residential. Still, the broker is concerned that, because of the late-cycle nature of the building products such as roofing, there could be a delayed impact.

UBS recently surveyed 40 steel buyers and 70% expect prices to be soft over the next three months. The broker cuts its FY20 spread forecast to US$255/t from US$300/t, the primary driver behind a -14% reduction to its FY20 estimates. This is partially offset by a lower Australian dollar.

Credit Suisse believes the trajectory of US and Asian spreads implies a materially weaker exit rate from FY19, and downgrades estimates for FY20 for the fourth time. The main queries the broker has are about where spreads will settle before improving, and how quickly building product volumes turn around.

The broker assesses prior down-cycles have been exaggerated by supply chain de-stocking and this results in distorted volume and price signals, setting the cycle up for an aggressive rebound when prices trough. To date, steel liquidity has not evolved into an increase in Chinese steel exports, despite record production. Credit Suisse believes it is critical to the outlook to ascertain whether Chinese exports will stay well managed, and whether declining profitability will initiate production cuts.

Strong fundamentals, including a circa-15% free cash flow yield, provide value through the cycle but Morgan Stanley asserts spreads still need to get better for this to be realised. The broker expects reduced spreads to persist in the short term, noting US and east Asian steel spreads are at their lowest point since 2016/17. A strong appreciation in raw materials in east Asia has caused the spread to narrow by -27%.

Morgan Stanley considers the stock by no means expensive and likes the fundamentals, albeit remains concerned about the trend. Hence, it will difficult for the stock to perform while the trend is negative. Macquarie is also concerned about the earnings momentum and envisages -35% downside risk to FY20 earnings on current spot settings. Citi, on the other hand, believes the downside risks are factored in and the risk/reward has turned favourable.

North Star

There are likely re-rating catalysts as steel markets bottom, Citi asserts, while the potential approval of the expansion at North Star and an ongoing buyback program are also supportive. Deutsche Bank, meanwhile, expects North Star spreads could fall another -US$50/t by FY21.

Ord Minnett is also concerned about the sanctioning of the North Star expansion in the current environment, as spreads are below viable levels and there are rumblings about oversupply in the US. The broker would prefer the North Star expansion was deferred.

Macquarie is worried about momentum, particularly given the US steel market outlook, and a North Star expansion decision is not factored into its estimates. The company continues to evaluate the expansion of North Star, commencing detailed design and engineering procurement and costing around US$50m. An update is expected in August.

Buyback Continues

The company has announced a further $250m in buybacks as part of its first half capital management. In contrast to prior years, BlueScope Steel expects to continue buyback activity during July 2019 and Citi believes this signals confidence in strong cash generation and a view that the shares are cheap.

The broker expects the company to maintain a $500m per annum buyback program and also fund growth projects. Macquarie now assumes a full $250m in the first half of FY20 and $420m for the financial year overall.

The extension of the buyback indicates the company is confident in the balance sheet cash outlook, Credit Suisse agrees, despite signs the North Star expansion will proceed.

FNArena's database shows three Buy ratings, three Hold and one Sell (Macquarie). The consensus target is $12.63, signalling 12.0% upside to the last share price. This compares with $14.31 ahead of the downgrade. Targets range from $9.20 (Macquarie) to $15.00 (Ord Minnett, Credit Suisse).

See also, BlueScope Steel Squeezed As US Tariffs Lifted on May 28, 2019.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

FNArena is proud about its track record and past achievements: Ten Years On

Link Administration Highlights Expansion

Link Administration is keen to highlight expansion and growth opportunities, although brokers remain concerned about pockets of weakness and volatility.

-Investigation into the Woodford fund adds further uncertainty in the UK -Brexit not cited by competitors as a source of UK weakness -Majority of growth options have long-term horizons

By Eva Brocklehurst

The investor briefing from Link Administration Holdings ((LNK)) showcased expansion and growth prospects, rather than dwelling on the recent FY19 guidance downgrade. The company did not provide more disclosure, although Citi notes the last few days have witnessed another increase in the level of activity and considers the Australian funds administration business stretched.

Elevated costs remain of concern and, while some of these may be ultimately recoverable, the path forward remains unclear. Management has indicated costs from the changes to the Australian Protecting Your Super program may remain elevated for another 12 months and it would start seeking compensation from funds.

UBS assesses, while the pressure from Protecting Your Super is likely to be temporary, revenue weakness in UK corporate markets most likely includes a recurring element because of client losses, in addition to the softness in transaction activity related to Brexit uncertainty. The broker continues to envisage FY20 as a transition year but believes the medium-term growth prospects remain sound.

Management has sought to reassure investors regarding its recent earnings yet Ord Minnett, on its calculations, still struggles to understand the explanation for the recent downgrade to guidance. The company reiterated that 60% of the downgrade to operating earnings (EBITDA) came from the Link Asset Services division, and most of this from the corporate and private client services, which is in the process of being sold.

The company has also indicated the rest of the weakness in this division stems from Brexit, although the broker has not viewed any similar concerns expressed by either Equiniti or Computershare ((CPU)).

Citi suspects that the impact of Brexit uncertainty on retained services is more than the company previously envisaged, given lower transaction revenue. UBS assesses registry client losses have played a role alongside lower IPO and transaction activity. Price competition has also been a factor.

Ord Minnett was pleased to note that if the Woodford fund, of which the company is authorised corporate director, was closed, the impact will be more than offset by other mandate wins. Credit Suisse believes the investigation into the Woodford fund adds further uncertainty over the short and medium-term and Citi agrees, noting that while the company has said it has done nothing wrong, the widely publicised case presents risk of reputation damage.

Growth Opportunities

Growth opportunities are primarily focused on expanding into adjacent markets or a broadening products. While the opportunities are strategically sensible and the company has the debt headroom to fund several bolt-on acquisitions, Credit Suisse believes execution risk is relatively high. Moreover, the time horizon for such expansion is 3-5 years and, therefore, it is unlikely to be material enough to counter the earnings headwinds in FY20 and FY21.

The exception being PEXA which is currently experiencing strong growth and margin expansion, driven by increased utilisation of the electronic property settlement service. The business is running ahead of prospectus forecasts because of a higher uptake in Western Australia, although total volumes in the market are down -20% from their peak.

Other growth opportunities include banking and credit management, in the regions of Italy, Netherlands and Cyprus. The initial focus will be Italy, to help replace peaking volumes in Ireland. Fund opportunities are also being canvassed in Luxembourg, where the company has established a footprint and recently won its first client.

Ord Minnett suggests Link Administration will require some form of acquisition to expand into banking and credit areas in Europe, either directly or through an adjacent business such as real estate services.

UK pensions are another area, where there is an opportunity to leverage the Australian pension offering. The company is also in the process of developing centres of excellence which include offshore hubs in India.

AustralianSuper

Link Administration has announced an extension to the AustralianSuper funds administration contract for a further four years, its largest client on the platform. Macquarie considers this a positive development, given the length of time it is taking to re-negotiate the REST contract.

Citi agrees the market should take comfort in the fact that the AustralianSuper contract has been renewed six months ahead of schedule. Still the broker doubts whether investor scepticism will dissipate, as the short-term headwinds remains significant.

FNArena's database shows six Buy ratings, one Hold (Citi) and one Sell (Deutsche Bank). The consensus target is $7.06, signalling 30.9% upside to the last share price.

See also, Uncertainty Prevails At Link Administration on June 3, 2019.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

FNArena is proud about its track record and past achievements: Ten Years On

CYBG Plans To Be In The Money With Virgin

Financial group CYBG plans to exploit its under-utilised customer base through enhanced products and services, re-branding as Virgin Money by the end of the year.

-Targeting a return on equity of over 12% in the medium term -Benefits long dated and margins likely to remain under pressure -To re-brand as Virgin Money and take advantage of wider recognition

By Eva Brocklehurst

Financial group CYBG plc ((CYB)), or the UK's Clydesdale Bank, provided many elements to its strategy briefing, targeting a higher mix of both personal and business lending and higher future net interest margins. Macquarie believes, if the bank can deliver on its goals, there is scope to close the valuation gap with large UK bank peers.

An effort will be made to exploit a sizeable, albeit under-utilised customer base through enhanced products and services. Capital remains strong and achieving medium-term targets is expected to result in a return on equity of over 12%. There is a high degree of self-help in the initiatives, which include -GBP$200m in net cost reductions by FY22.

Revenue will be driven by a shift in asset and liability mix rather than outright growth, which is expected to support net interest margins. Profitability will be prioritised over growth, and the bank is targeting system growth for mortgages while aiming to grow business and unsecured lending at above-system levels.

Shaw and Partners takes issue with these expectations derived from the change in asset mix. Currently, mortgages represent 84% of the loan portfolio, business loans 10% and unsecured personal lending 6%.

The plan over the medium term is to grow unsecured personal loans to represent 10% of the portfolio at the end of three years. Business loans are expected to grow to represent 15%. Achieving these targets requires a 26% increase in unsecured personal loans and 22% increase in business loans and, on the broker's calculations, these are considered "more than optimistic".

Citi is happy with a strategy that is based on a strong brand, self-help and considers the new FY22 targets achievable. There is enough detail to make the broker confident in its Buy rating. Still, only small upgrades are expected to estimates as lower costs are offset by lower revenues. Morgans also suspects the tailwinds from strong growth in low-cost deposits will be largely offset by intense competition in the mortgage market.

Shaw and Partners asserts that the achievement of a return of 12% would be remarkable, in view of the historical and near-term forecast performance of the business. The broker considers it peculiar there was no income growth targeted through FY19-22, despite the high growth rates expected for assets and funding. The only conclusion the broker draws is that net interest margin declines are likely to be significant.

The broker, not one of the eight stockbrokers monitored daily on the FNArena database, retains a Sell rating and $3.20 target. The database has two Buy ratings (Citi, Macquarie) and one Hold (Morgans). Macquarie has a target of $5.30 and Morgans, $3.57.

Investors have always been concerned that the benefits from the bank's re-vamp will be long-dated and Citi acknowledges a margin of safety is needed as margins are likely to remain under pressure, given strong UK banking competition. The broker suspects it is too early to give CYBG full credit for cost delivery and low provisions. Nevertheless, the improving return profile overall makes the bank attractive on a medium-term view.

Bell Potter considers the detailed disclosures provide a classic cost reduction story, amid plenty of capital and the resilience to ride out volatile market conditions. The broker, not one of the eight, has a Buy rating and $4.10 target.

More Targets

Management is now targeting a cost-to-income ratio in the mid 40% region by 2022. This is important, in Macquarie's calculations, as asset growth was not specifically targeted and, based on the expected transition in the loan mix, implied growth rates appear unrealistic. Macquarie calculates that a cost-to-income ratio of 45% would deliver 2022 earnings broadly in line with current estimates.

The broker notes the target for the CET1 ratio of 13% is below the first half level of 14.5% and, together with annual capital generation of over 100 basis points by 2022, may allow for share buybacks in the future in addition to

dividends. Dividends are expected to rise as the pay-out ratio increases to around 50%.

The broker finds the total capital return potential attractive, noting the potential for capital returns over and above ordinary dividends by 2022 was explicitly referenced by management. However, Morgans expects subdued revenue growth over the medium term and considers special dividends or share buybacks are unlikely.

Virgin Money

CYBG intends to re-brand to Virgin Money and take advantage of the wider recognition of the name, connecting with a wider global audience for Virgin companies. Surveys suggest there is higher customer affinity for the Virgin brand and it also attracts a more affluent customer.

Following the acquisition of Virgin Money, the bank now has the scale to compete nationally. Macquarie notes a disruptive strategy is planned and the business should be positioned between the large UK banks and the challenger banks.

CYBG expects to offer customers a different form of loyalty scheme rather than only one with simple monetary rewards. The funding mix will be changed to attract lower-cost relationship balances and use them to replace the relatively more expensive Virgin Money retail savings deposits.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

FNArena is proud about its track record and past achievements: Ten Years On

Thucydides Trap And Gold

Richard (Rick) Mills Ahead of the Herd

As a general rule, the most successful man in life is the man who has the best information.

Thucydides Trap and gold

When an emerging power attempts to supplant a hegemonic power in international politics, major conflict often ensues. This is the definition of "The Thucydides Trap" as explained in a recent op-ed piece in The Japan Times.

The Thucydides Trap (pronounced "thu", like you have a heavy lisp + sid + idees) is a term invented by Graham Allison, a professor at Harvard's Kennedy School of Government. Alison has been saying since 2015 that war between a rising power, China, and an established power, the United States, is inevitable, based on historical examples. The argument is fleshed out in his book, 'Destined for War: Can America and China Escape Thucydides's Trap?'

Allison's Thucydides Trap has become a popular topic of conversation among the chattering classes in these troubling times in America, especially with a loose cannon like Trump as the tweeter-in-chief who has the keys to the nuclear button. As positions in the trade dispute get more entrenched, and issues like Huawei crop up, many are talking about a march to war with a new adversary: China.

Steve Bannon famously stated that he sees such a war as inevitable within five to 10 years. Trump campaigned on a promise to address the widening trade deficit between the two countries. He complained about the low Chinese currency, the yuan, hurting US manufacturers. Jobs were leaving for lower-cost jurisdictions like China and Mexico.

War almost certainly wasn't on Trump's mind when his administration began implementing a series of tariffs, initially for aluminum and steel. A little over a year later, however, the extent of the tariffs and the antipathy between China and the US have spread considerably; tariffs now encompass over half of the roughly $500 billion in goods that China exports to the US, and almost all American goods imported by China.

A large part of the trade impasse is over protection of intellectual property rights and access to the Chinese market of 1.3 billion consumers. This is underpinned by the need to be first in technology ie. the leader in production of semiconductors, smart phones, cellular networking (5G), robotics, artificial intelligence, etc.

It's not that big of a leap to go from a clash of economics to a serious conflagration that results in a shooting war. The US pulled out of the INF Treaty restricting intermediate-range nuclear missiles, so we already have an arms race building between the US, Russia and China. We correctly predicted rare earths could be used as pawns in the trade war. Building missiles and other military hardware requires rare earth elements - simply put, China has them and the US doesn't.

We also have heightened tensions in the South China Sea, which China claims as its own and the US insists is an international waterway; over Taiwan, a chunk of the former Chinese empire that went independent, but that China considers part of its territory it will fight to defend; and over North Korea's nuclear capabilities.

Defending South Korea is one of the US Military's most important mandates in the Pacific theater. For China, continued propping up of Kim Jong-un's regime through strong trade linkages and aid (last year Beijing said it will invest $88 million in the North's infrastructure such as a new border bridge), serves to consolidate Chinese power in North Asia, and to prevent a major refugee crisis should the North and South unite as East and West Germany did in 1989.

At Ahead of the Herd, we've been talking about a potential war between China and for over a year. It's not news to us. What is new, is the "mainstreaming" of the topic. In this article we ask the question: How likely is it that the US could go to war with China?

To tackle this question, we need to first look at the current situation the world's two superpowers find themselves in. Next, an admittedly academic exercise, but very interesting to run through, as to what could happen. Here we take a dive into The Thucydides Trap. Then a discussion of how war could be avoided. And finally, what can investors do to protect themselves?

The great leap over poverty

Forty years ago China was an economic backwater. Despite being the dominant landmass in North Asia, and butting up against “the Evil Empire” Russia, nobody paid much attention to communist China. Southeast Asia was contained following the bloody, divisive conflict in Vietnam. American troops were in Korea. At the time the only threat coming from Asia was cheap Japanese cars.

2018 marked the 40th anniversary of China’s economic reforms and opening-up policy led by Deng Xiaoping, China’s forward-looking president who took over after Mao Zedong’s death in 1976.

Comparing the China of 2018 to the China of 1976 yields some astonishing figures. The first is how successfully China has rid the country of poverty. In ‘78 90% of the Chinese people lived on $2 a day, what the World Bank considered “extreme poverty”. The Chinese government may have wanted to end its isolationist policy under Deng, but it wasn’t too interested in raising the living standards of its citizens. People living in extreme poverty are more worried about their next meal than fighting the government, which is just the way the Communist Party liked it. China had its peasant-led revolution, the party didn’t want another.

Gradually though, reforms did occur, and Chinese citizens began to earn more. Now, only 1% of people live below the poverty line; 800 million have seen their incomes rise above it. According to the Chinese government (admittedly a questionable source), 250 million people in rural China lived in poverty in 1978, compared to 30 million at year-end 2017. The poorest residents saw an incredible 50-fold increase in their standard of living.

“Between 1981 and 2004, China succeeded in lifting more than half a billion people out of extreme poverty, said Robert Zoellick, then-president of the World Bank. “This is certainly the greatest leap to overcome poverty in history.”

With that massive improvement in living standards, China’s economic power has grown at warp speed. Bloomberg notes that in 1978 the country represented 1% of the world’s GDP; by 2017 it was 15%.

We all know the story of what happened to China in the 2000s. Its GDP raced along at double-digits for nearly a decade. The country became the largest commodities consumer in the world, the most important market driver of raw materials like copper, iron ore (used in steelmaking), coal, oil and soybeans.

Today, anybody who knows anything about commodities keeps a close eye on China.

China’s open-ness to world trade meant that in 2001, it was let into the World Trade Organization - effectively earning the country membership into the Western club of developed nations. Those nations, particularly the United States, presumed that China would thus become more “Westernized” and respect the status quo. In fact, what has happened, is that China has taken over a lot of what the US used to control.

For example, at the beginning of the 21st century, the US was the dominant trading partner of every Asian nation; now that position belongs to China. According to Allison, the Harvard prof and conceiver of The Thucydides Trap, this is like a red cape to a charging bull. Ruling powers do not like to be challenged.

“When a rising power threatens to displace a ruling power, this creates a dangerous dynamic in which both the rising and ruling powers are vulnerable to third-party provocations that would, in normal conditions, be inconsequential or easily managed but that can trigger a spiral to a result neither of the primary competitors wanted,” Allison told the 2019 Harvard Alumni China Public Policy Forum in Beijing this March, in a speech titled ‘How to Escape the Thucydides Trap’.

The Gospel of Xi

It might be hard for Westerners to understand the Chinese perspective. We know the Chinese government wants to have better lives for its citizens, to become richer, to have better jobs, higher-educated kids, more brand-name stores, etc. Essentially, to become more like us. Isn’t that the goal of every developing nation? Well yes, and no.

In China’s case, it goes much further than that. Chinese leaders see their country as a lost empire that needs to be regained, respected, both loved and feared. They want China to assume its rightful place in the world; for them, this means the most powerful, envied and emulated nation on earth.

Back in 2014, before all this hubbub over tariffs, an important book was published in China. It was called ‘The Governance of China’, a collection of political theories by President Xi Jinping.

Chinese media claim over 5 million copies have been sold worldwide, though few in North America have probably seen or read it. Perhaps they should though, as it contains some valuable insights into the mind of China’s most powerful leader since Deng Xiaoping.

In the West we tend to think of our leaders as temporary. Not so in China. Last year the Chinese Communist Party voted to abolish presidential term limits, allowing Xi to stay on indefinitely as leader, and to implement his agenda. It’s every dictator’s dream.

But a nightmare for the rest of us. In a book review published by The Atlantic, author Benjamin Carlson, Beijing correspondent for Agence France-Press. describes Xi's ideology, or "Xiism":

What emerged for me was Xiism—what I'd describe as an ethno-nationalist variant of Marxism, which holds that the people of China are heirs to a unique civilization and a utopian destiny that entitle them to a privileged position in the world. This destiny can only be achieved by following the moral leadership of Xi Jinping, who in his person (due to his birth and upbringing) embodies the virtues of the people and is their champion.

If Xi's program is duly followed, Xiism promises a pinnacle of prosperity in 2049—precisely 100 years after the founding of the People's Republic of China—at which point Xi avers that the Communist Party will "solve all the country's problems" and the Chinese Dream will be fulfilled. China will be "strong, democratic, culturally advanced, and harmonious," he vows, adding that in his view, "realizing the great renewal of the Chinese nation is the greatest dream in modern history."

A knowledge of history is important here. Hundreds of year ago China was the undisputed ruler of North Asia. Chinese history is a series of dynasties. The last dynasty was the Qing, or Manchu; the Qing held power for 268 years, from 1644 to 1912. At the peak of its empire the Qing controlled 13 million square kilometers of territory including parts of modern-day Vietnam, Myanmar, Tibet, India and North Korea. Among its major achievements were an expansion of foreign trade, the creation of vast encyclopedias (the Imperial Encyclopaedia written between 1700 and 1725 reportedly contained 10,000 volumes), a large body of literature, development of the Peking Opera, and advances in painting, porcelain and printing.

In this context, President Xi's recent visit to a rare earths plant, and a speech he made urging comrades to dig in for the long and difficult road ahead, makes perfect sense. The symbolism was clear: Even if the trade war lasts decades, the equivalent of the Long March of 1934 which preceded the emergence of the Chinese Communist Party and Mao Zedong, China will ultimately prevail. When it does, Xi will be the leader of "a new China" in much the same way as Chairman Mao.

Also notable in Xi's book is the near-complete absence of the United States. In Xi's world, the US, writes Carlson, is neither friend nor "partner" in non-confrontation. Rather, the US is seen as an insignificant, faraway blip, and countries that China can manage mostly without fear (Russia) or regard benevolently as obedient tributaries (Tanzania) fill the void.

The book is also a testament to the construction of Xi's persona, and how the state is tapping into both imperial tradition and lingering nostalgia for Red China to present the Chinese leader as everything to everybody: a Marxist messiah for leftists, a people's emperor for peasants, and a righteous, thundering Jeremiah for urban constituencies fed up with corruption.

This is the Gospel of Xi.

Powerful stuff. There are of course historical parallels. Russia's diminishment to a middle European power with an economy around the size of France longs, in the hands of a strong leader like Putin, to get Mother Russia back. Annexing Crimea was a good start. Or inter-war Germany which was so punished by the Allies after World War I, that the ground was ideal for National Socialism to take root.

Allison looks at history from a different, though related lens. He believes nations act purely out of self-interest (in this respect he is in the tradition of Thomas Hobbes, who wrote "life is nasty, brutish and short") and that conflict is pretty much inevitable when a powerful up-and-comer nation is trying to usurp the incumbent country's dominance.

The Thucydides Trap

This is what Allison refers to as the Thucydides Trap. Its namesake was a Greek historian who gave an account of the Peloponnesian Wars in the 5th century BC, between Sparta, the champion, and Athens, the challenger.

Thucydides concluded "it was the rise of Athens and the fear that this instilled in Sparta that made war inevitable". Why couldn't they just work out their differences? According to the theory it's this unique situation - where a zero-sum mentality forms in the minds of the pursuer and the pursued, characterized by overconfidence of the rising power, and loss of confidence/ paranoia of the declining hegemon - that causes the powers to fall into the "trap" of war.

Allison combs through 500 years of history to come up with 16 examples of the Thucydides trap; of these, an astonishing 12 examples resulted in war - or 75%.

His main focus is to outline where the US and China are with respect to realpolitik, or practical considerations, and how to avoid war. The signs are not good.

Writing in The Atlantic, Allison states that “Based on the current trajectory, war between the United States and China in the decades ahead is not just possible, but much more likely than recognized at the moment.” That was written in 2015, before the trade war started, so the case for war is even stronger now.

According to Allison, events that could make two nations fall into the trap may be small, “business as usual” conflicts that, if they occurred in a different dynamic, would lead to nothing. For example, the assassination of Archduke Ferdinand, a relatively obscure and minor figure, was the spark that lit a whole conflagration of events that plunged Germany, an ascendant maritime power, into war with Britain, whose Royal Navy ruled the seas for decades. Consider the current conflicts between the Chinese and US navies in the South China Sea and the Taiwan Strait. It would not take much - say a collision between two warships - to ignite the powder keg of war.

However, for the threat to be taken seriously, the rising power must have the capability to take on the incumbent power. Henry Kissinger, the US former secretary of state, wrote that “once Germany achieved naval supremacy … this in itself - regardless of German intentions - would be an objective threat to Britain, and incompatible with the existence of the British Empire.”

Again the current situation doesn’t bode well. China has bulked up its military and it now spends more on its armed forces than any other country in the world except the United States. And changes are occurring with China’s military institutions. In a feature article titled ‘The China Challenge: Marshall Xi’ Reuters writes that President Xi has refashioned the People’s Liberation Army, the PLA, into a force that is rapidly closing the gap on US firepower. In fact, the US could even lose, if the two sides were to meet in combat:

In just over two decades, China has built a force of conventional missiles that rival or outperform those in the U.S. armory. China’s shipyards have spawned the world’s biggest navy, which now rules the waves in East Asia. Beijing can now launch nuclear-armed missiles from an operational fleet of ballistic missile submarines, giving it a powerful second-strike capability. And the PLA is fortifying posts across vast expanses of the South China Sea, while stepping up preparations to recover Taiwan, by force if necessary.

For the first time since Portuguese traders reached the Chinese coast five centuries ago, China has the military power to dominate the seas off its coast. Conflict between China and the United States in these waters would be destructive and bloody, particularly a clash over Taiwan, according to serving and retired senior American officers. And despite decades of unrivaled power since the end of the Cold War, there would be no guarantee America would prevail.

Indeed the US appears to be girding for such a military challenge. Bloomberg reports that the Pentagon has been working to overhaul the “two-war” defense strategy that has been the playbook for the last couple of decades - in other words, preparing to fight one major war as opposed to two smaller conflicts simultaneously. The one-war strategy is rooted in the idea that defeating a great-power adversary like China or Russia would be more difficult than anything the US has done in decades, and is a 180 degree shift from the DoD’s focus on counter-terrorism that has dominated the thinking since 9/11.

The U.S. is now building a force not around the demands of two regional conflicts with rogue states, but around the requirements of winning a high-intensity conflict with a single, top-tier competitor — a war with China over Taiwan, for instance, or a clash with Russia in the Baltic region.

There is plenty of serious thinking behind this shift. The new strategy is meant to signal unambiguously - to allies, competitors and the Pentagon bureaucracy - that the U.S. is now focusing squarely on great-power competition and the immense challenges it presents for a force that has been preoccupied with counterterrorism and counterinsurgency for nearly two decades. It recognizes that America’s military advantages vis-à-vis China and Russia have eroded gravely, and that the Defense Department will need new high-tech capabilities and creative operational concepts to defeat either country should war break out.

Back to Allison, the Harvard prof and author agrees that The preeminent geostrategic challenge of this era is not violent Islamic extremists or a resurgent Russia. It is the impact that China’s ascendance will have on the U.S.-led international order, which has provided unprecedented great-power peace and prosperity for the past 70 years.

For those who doubt that China is big enough or strong enough to displace the United States as the top power in Asia, Allison invokes Lee Kuan Yew, who ruled Singapore for three decades, was a mentor to Chinese leaders since the late 1970s, and up to his recent death, was the world’s most prominent China-watcher.

LKY, as he was known, put the odds of China continuing to grow at rates several times greater than the United States over the next decade or so as “four chances in five.” As for China displacing the US, Singapore’s strongman leader reportedly said, Of course. Why not … how could they not aspire to be number one in Asia and in time the world?” And about accepting its place in an international order designed and led by America, he said absolutely not: “China wants to be China and accepted as such - not as an honorary member of the West.

Allison concludes by asking, where does this rivalry stand today? Right on track. If Thucydides were watching he would say this looks like the grandest rising power I ever saw, accelerating towards the most colossal ruling power I ever saw. Well, we've got an unstoppable force and an immovable object. I'm looking forward to seeing the grandest collision of all times. I think that's what he would say. The strategic rationale, in particular, that gave a picture of what would be U.S.-China relations would be, has collapsed both in Washington and in Beijing.

Other credible sources agree that a confrontation between the United States and China is a very real possibility. The Belfer Center from Harvard's Kennedy School of Government opines:

Today, as an unstoppable China approaches an immovable America and both Xi Jinping and Donald Trump promise to make their countries "great again," the seventeenth case looks grim. Unless China is willing to scale back its ambitions or Washington can accept becoming number two in the Pacific, a trade conflict, cyberattack, or accident at sea could soon escalate into all-out war.

And economics professor Nouriel Roubini, known for predicting The Great Recession, notes in Project Syndicate that a trade war now threatens to escalate into a permanent state of mutual animosity. This is reflected in the Trump administration's National Security Strategy, which deems China a strategic "competitor" that should be contained on all fronts.

A full-scale cold war thus could trigger a new stage of de-globalization, or at least a division of the global economy into two incompatible economic blocs. In either scenario, trade in goods, services, capital, labor, technology, and data would be severely restricted, and the digital realm would become a "splinternet," wherein Western and Chinese nodes would not connect to one another.

Stumbling into war

So how might it happen? According to Allison, it would be the perfect storm of misperceptions or miscalculation, combined with politics, wherein the risk of letting your opponent out-flank you to the right on a national security issue, forces the governing party to become even more hawkish, and take on more risk:

So stack these three things on top of each other, reality, perception, politics, and this creates a huge vulnerability to some extraneous action or some third party action, that becomes a trigger that produces a spiral that produces the war.

Allison argues that, in order to avoid the trap, the two nations need to recognize the danger of a shooting war, then find a way(s) to avoid it. However, not everyone agrees that the Thucydides Trap is the right paradigm for our times, nor that avoiding conflict is the way forward.

In a 2017 op-ed piece published in The Strait Times, Arthur Waldron, a professor of international relations at the University of Pennsylvania, called Allison's book "baffling academic farrago." Waldron thinks Allison has "China fever" for his various praises of the Middle Kingdom, and believes that turning the other cheek as Allison suggests the ascendant power should do, is actually a recipe for war.

He compares Obama's failed "pivot to Asia" during the 2000s - whereby the former administration was unable to stop China from creating fortified islands in the South China Sea, and North Korea from shooting off test missiles - with the Munich Agreement of 1938, that forever tainted Neville Chamberlain, Britain's then-PM, with the brush of appeasement for ceding Czechoslovakia's Sudentenland to Nazi Germany. He calls this the "Chamberlain Trap":

"Appeasement of aggressors is far more dangerous than measured confrontation." Waldron writes. "Did China become more aggressive in the South China Sea in the 2000s because the Obama administration got tougher or because it went AWOL on the issue? I'd say the latter is more likely.

With China, we might want to be more mindful of the Chamberlain Trap (named after the peace-loving prime minister of England, one of the authors of the disastrous 1938 Munich Agreement that sought to avoid war through concessions), which taught Hitler that the British were easily fooled. That is the trap we are in urgent need of avoiding.

Trade war to currency war

We have been speaking ominously of some type of armed confrontation between the US and China. So far however all the bullets that have been fired have been shaped like dollar signs. The situation as it stands, is we have a trade war, becoming more and more intractable, as it becomes tied to technology (Google said on Wednesday it is shifting production of US-bound motherboards out of China and into Taiwan. Huawei, the Chinese tech giant, is not counting on a trade war settlement and is reportedly shifting supply chains and making other preparations for a prolonged fight.)

Two options at Beijing's disposal are to sell US Treasuries, of which China is by far the dominant holder, and to "weaponize" the yuan. The US could also devalue the dollar.

A large-scale sale of US debt on the bond market would cause US interest rates to rise, bond prices to tank and yields to go ballistic. The latter would exacerbate federal budget deficits, because interest payments would rise on the national debt.

The US dollar would plummet, as a loss of confidence in the greenback ripped through the global economy.

Regarding devaluation, it has recently come up for discussion whether China should knock down the yuan as a way to pressure the United States into making a trade deal.

While China's central bank has been pursuing a policy of propping up the yuan's value as the country shifts from an export-driven to a consumer-oriented economy, Forbes quotes Chen Long, a China economist at consultancy Gavekal Dragonomics, stating it is now in Beijing's best interest to let the yuan slide:

"The renminbi exchange rate is one of the most powerful weapons Beijing has in the trade war with the U.S.," Chen wrote in a report. Chen argues that a weaker yuan would support China's exporters. While China's importers would be worse off, the benefits outweigh the costs because China is a net exporter. But, more importantly, a depreciated renminbi [aka the yuan] could rattle global markets and, consequently, pressure Trump to switch tack.

We've now reached the point in time when both countries would benefit from weaker currencies. Trump has frequently launched into Twitter tirades directed at the US Federal Reserve for keeping interest rates too high, along with the dollar. Trump wants the dollar to trade lower in order to help US exporters, and to rein in the China-US trade deficit - something he has been passionate about doing, since he believes that manufacturing jobs will then migrate back to the US from overseas.

In other words, we're heading for a currency war. A currency war is what happens when countries intentionally devalue their currencies through their central banks. Increasing the money supply lowers interest rates and the value of the currency, thereby depressing the exchange rate.

Those on the losing end of trading relationships decide to engage in a policy of competitive devaluation. By keeping their currencies low, exports will be cheaper, imports more expensive.

The problem for the United States is that throughout the past several years, the dollar has remained high in relation to other currencies, and that has created a large trade deficit. That's a problem because the US imports more than it exports – meaning consumers are buying more goods and services from abroad than locally. Exporters face resistance from buyers because products priced in dollars are more expensive.

It is primarily the result of the trade deficit - and especially the trade deficit with China - that prompted the Trump administration to start a trade war with China.

Who would win a currency war between the US and China?

On the one hand, devaluation would be good for China's exports, but on the other hand, Chinese companies importing American products must shell out more yuan to get the same number of dollars as before the currency got devalued. The extra cost would probably be passed onto consumers. China exports to the US much more than it imports from America, though, so on balance, this strategy of "weaponizing the yuan" would favor China.

The wrong kind of president

The Thucydides Trap posed by Prof. Allison is a good model for analyzing great-power relationships, but it's on "how to avoid war" that the paradigm breaks down. The reason is that avoiding war and trying to find accommodation turns on highly skilled diplomacy. To be blunt, this administration doesn't have it.

The first problem is that Trump, not surprisingly given his business background, thinks he can solve all foreign policy quagmires by sitting down "mano a mano". This isn't the way diplomatic relations between countries is supposed to work. The Washington Examiner explains:

Although the president's job is, in part, to build strong and lasting relations with other world leaders, those relations should be professional rather than personal. Indeed, that the president would refer to adversarial foreign leaders as "friends," never mind that his own advisers have identified them as threats, is alarming and points to a lack of understanding of volatile foreign relations.

The other issue with this approach is it presumes no continuity between administrations. The next administration after Trump's will be dealing with another president (assuming it's not him).

This partly explains why the Trump administration really has no game plan when it comes to statecraft. If Trump has a strategy in dealing with Beijing, nobody, except him, knows what it is.

Kumi Miyake, president of the Foreign Policy Institute and research director at Canon Institute for Global Studies, fleshes this out nicely in a recent op-ed published in The Japan Times. He takes the Thucydides Trap in a different direction though, writing that the problem with not having a strategy is the risk of appeasement or of taking your eye off the ball:

The real danger now is that there seems to be no coherent and prioritized national security strategy inside the Trump White House. If such a situation continues, the United States may not be able to properly respond to and deal with the next crisis in which China or any other rising powers may be involved.

This is not a crisis caused by the Thucydides' Trap. Rather, it is a crisis either by the "Chamberlain's trap," which led to the disastrous Munich Agreement and eventually to World War II, or by the "power vacuum trap," in which an established power gives a rising power an easy chance to fill the vacuum and dominate the theater.

Either way, the established power will lose the game after fighting unnecessary wars or even without fighting. This is the real danger for an established power facing a rising power. To avoid these traps, all you need is a coherent and professional strategy under a non-impulsive, well-informed and disciplined president.

We certainly don't see the Trump administration appeasing China, but we do see the fallout from its hard-line approach to Beijing. A recent example is Mexico planning to hold "high-level meetings" with Chinese officials, in the wake of Trump threatening to bash Mexico with tariffs if the country failed to stem immigration from South America.

Or the cavalier way Trump treated Canada, by slapping aluminum and steel tariffs on the US' second-most important trading partner, ripping up NAFTA, and snubbing Ottawa - two and a half years into his mandate, Trump has still not visited Canada. Most new presidents make Canada the first international trip they make after inauguration.

That's cause for concern, but what is really frightening is how Trump deals with problems seemingly with no consultation, no briefing, and no thought to the consequences. In statecraft, this is dynamite. Imagine Trump negotiating his way through the Cuban missile crisis, or the Iran hostage incident. Foreign governments aren't usually keen to "make a deal" when politics and religion are on the line. These situations require a deft touch, not a sledge hammer.

In May, Foreign Policy Magazine detailed the dangerous escalation the White House is pursuing in Iran - now the subject of renewed US sanctions for its refusal to dismantle its nuclear energy program:

Thousands of U.S. troops and Iranian-backed forces operate in close proximity to one another in Iraq, Syria, and the crowded waters of the Persian Gulf. Saudi Arabia and the United Arab Emirates continue to pursue their air campaign against Iranian-backed Houthis in Yemen despite international outrage over the world's worst humanitarian disaster there. And Israel regularly conducts military strikes against Iranian arms shipments and infrastructure in Syria. In this volatile context, the scenarios for an intentional or inadvertent U.S.-Iran war are legion.

If Iran or its proxies respond to U.S. pressure in ways that draw American blood or deal a major blow to critical oil infrastructure in the region, things could quickly get out of hand.

All else being equal, Trump probably doesn't want another U.S. war in the Middle East. But, if past is prologue, his gut instinct will be to respond (likely via Twitter) to any Iranian provocation with bellicose rhetoric that pours fuel on the fire.

Conclusion: own gold

Nobody can say for sure whether we are looking at an escalation or de-escalation of the affairs of state between the United States and China, but we can say with absolute certainty that it's a good idea to buy some insurance in case things take a wild turn for the worse. And given Trump's track record, we should all be nervous.

What do scared citizens do when they fear an economic or political crisis initiated by a renegade leader like Donald Trump? They turn to hard assets like gold.

Indeed gold's status as store of value, as money, the only currency available when yours is worthless, has come into play time and time again, when tensions heat up.

Gold gives all of us something that fiat currencies (paper money), or any other financial innovation, cannot deliver. Gold is insurance, irreplaceable in its functions.

Moreover, there are a number of demand-side reasons for owning gold right now. They include a series of economic indicators showing that US growth is grinding to a halt; worsening yield curve inversion; a potential trade spat with Europe waiting in the wings, as the US-China trade war appears no closer to a resolution; and the increasing tension between China and the US over Taiwan and the South China Sea.

Take all those factors, add in a flight to safe havens like gold, and you have all the makings of a powerful and prolonged bull market for gold just as we are entering the most active time of the year for junior resource companies.

With all that is going on in the world, we believe the gold price will do well over the next few months.

Richard (Rick) Mills

rick@aheadoftheherd.com

Richard is the owner of Aheadoftheherd.com and invests in the junior resource/bio-tech sectors. His articles have been published on over 400 websites, including:

WallStreetJournal, USAToday, NationalPost, Lewrockwell, MontrealGazette, VancouverSun, CBSnews, HuffingtonPost, Londonthenews, Wealthwire, CalgaryHerald, Forbes, Dallasnews, SGTReport, Vantagewire, Indiatimes, ninemsn, ibtimes and the Association of Mining Analysts.

If you're interested in learning more about the junior resource and bio-med sectors, and quality individual company's within these sectors, please come and visit us at www.aheadoftheherd.com

Content included in this article is not by association necessarily the view of FNArena (see our disclaimer).

Legal Notice / Disclaimer

This document is not and should not be construed as an offer to sell or the solicitation of an offer to purchase or subscribe for any investment.

Richard Mills has based this document on information obtained from sources he believes to be reliable but which has not been independently verified.

Richard Mills makes no guarantee, representation or warranty and accepts no responsibility or liability as to its accuracy or completeness. Expressions of opinion are those of Richard Mills only and are subject to change without notice. Richard Mills assumes no warranty, liability or guarantee for the current relevance, correctness or completeness of any information provided within this Report and will not be held liable for the consequence of reliance upon any opinion or statement contained herein or any omission.

Furthermore, I, Richard Mills, assume no liability for any direct or indirect loss or damage or, in particular, for lost profit, which you may incur as a result of the use and existence of the information provided within this Report.

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.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

FNArena is proud about its track record and past achievements: Ten Years On

Thermal Coal Glut: Who Will Blink First?

Thermal coal is piling up as demand drops away in Europe. Atlantic suppliers are turning their attention to the Pacific but, brokers assess, this region is also oversupplied.

-Switch to gas significant in thermal coal demand destruction in Europe -Supply reductions needed in high-energy coal to steady the price -Where will supply reductions emanate from: Columbia or Australia?

By Eva Brocklehurst

Demand for thermal coal is falling, particularly in the Atlantic, as coal-to-gas switching has become a driver of demand destruction in Europe. Brokers note this has ramifications for the Pacific, as suppliers look to Northeast Asia to absorb the glut.

Atlantic coal prices have not staged a recovery at the start of the northern summer, as Credit Suisse had hoped. Power plants are normally expected to re-stock, lifting coal prices, but this has not happened. Moreover, as the northern summer weather improves, renewable generation lifts and takes market share. Credit Suisse flags the fact the UK recently passed 10 days without any coal generation because of warm and windy conditions.

Meanwhile, German coal generators are losing money on falling power prices and rising carbon prices. Credit Suisse assesses thermal coal is under pressure in Germany regardless of the price, as around one quarter of the country's capacity is due to close by 2022 and the deluge of cheap gas is likely to speed this transfer up. Large quantities of gas are coming from Russia and Norway and US LNG is also flooding terminals, as Asian markets are seasonally soft.

Spanish generation in April also showed a clear switch to gas from coal following the removal of a tax for gas-fired generation. Macquarie also finds it hard to envisage how a revival over the northern summer will give a lasting boost to thermal coal prices.

For those shipping from the Atlantic, Asia has become attractive as the Atlantic-Pacific spreads cover the freight costs. However, demand conditions in the Pacific are not robust either and additional supply is bringing down prices.

Japan has been the leading importer in the region of high-energy thermal coal, but its utilities are under pressure to move away from coal and, as Morgan Stanley points out, coal-fired projects totalling around 4GW have been cancelled recently. The broker notes Japan's coal-to-gas switching has not really been forthcoming either, as most LNG to Japan is sold on oil-indexed contracts rather than at spot prices, making gas still uncompetitive versus coal.

Macquarie calculates that at least a fifth of seaborne trade is out of the money and thermal coal is suffering from a "demand problem", being displaced by other sources, namely hydro in China and gas in Europe. Moreover, warmer weather can only do so much to lift electricity production in China, the broker asserts, if manufacturing continues to slow as implied by China's weak June PMI data.

One item worth monitoring, in the broker's view, is that Shell and Tokyo Gas have agreed on the first coal-index LNG contract in April and this may trigger more switching if such indexing is more widely adopted. Meanwhile nuclear re-starts and cost-competitive renewables are also threatening thermal coal's market share in Japan.

Price Outlook

Credit Suisse suspects its forecast for a second-half thermal coal price FOB Newcastle of US$85/t is problematic. As Colombian prices are falling towards their 2016 lows, the broker is looking for what might be the floor. A floor price for China's thermal coal, which is largely self supplied, at a level authorities would accept, is calculated at around RMB530/t.

On parity, Credit Suisse assesses this means the absolute lowest Newcastle 6000 calorie thermal coal, as a monthly average, should be is around US$57/t. However, there needs to be a premium for high-energy coal, as it has to be washed to reduce the ash content to below 15%. Calculating a premium for Australia's Hunter Valley coal, the broker suggests, should be in the region of 22%, in order to break even.

Brokers believe supply reductions are needed in high-energy coal to steady the price. Although Morgan Stanley expects a recovery in demand from Japan and South Korea over the summer, supply will still need to exit to bring the market back in balance, as imports to these two countries are expected to gradually decline over the medium-term.

Higher cost exporters with more supply, such as Indonesia, which have mainly low-energy coal, are defying fundamentals at present, yet Morgan Stanley expects that country's rising exports will ease. As this supply exits the market and the current surplus narrows, the broker forecasts the thermal coal price to recover modestly to around US$81/t FOB Newcastle in 2020.

Meanwhile, Australian thermal coal exports were up 2% from January to April, with just 7% of supply negative at current spot prices. In Australia, small marginal mines account for around 40mt of supply which is currently out of the money and, Macquarie points out, most Australian thermal coal exports break even between US$50-$70/t and remain profitable.

Supply Cuts?

China, which drives the seaborne market in the Pacific, is experiencing weak demand and, although being largely self supplied, the 5500 calorie price has dropped below RMB600/t. The one bullish offset, Macquarie suggests, is that growth in Chinese output has fallen back to nil. Authorities have put pressure on domestic mines after a number of deadly accidents and new capacity additions have slowed.

Yet, Credit Suisse notes soft coal demand in China will affect Indonesian and Australian high-ash coal. Taiwan's power company recently tendered for Australian coal but only because it was a lot cheaper than its contracted supply. The tender was also heavily overbid which signals to the broker that producers have around 1.6mt of coal to move.

All up, Credit Suisse asserts there is too much coal being produced to absorb right now and the question is whether Hunter Valley or Colombian producers cut supply. Major Colombian producers include Glencore, BHP Group ((BHP)) and Anglo American.

The broker suspects Glencore may be prepared to halt some of its mines for long periods, as it has done in other commodities, in order to tighten the market, but would have to decide between its Colombian or Australian mines. In contrast, BHP, the other global miner heavily involved in both these markets, has in the past continued to run its mines hard regardless of the price.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

FNArena is proud about its track record and past achievements: Ten Years On

Material Matters: Copper, Steel & Manganese

A glance through the latest expert views and predictions about commodities. Copper; steel; manganese; iron ore miners; Queensland petroleum royalties.

-Supply-side disruptions in copper unlikely to affect price in current environment -How long can property drive apparent steel demand in China? -Manganese continuing to perform poorly, lacking supply constraints -Strong upgrade cycle for iron ore miners as supply still constrained -Petroleum royalties review to the fore in Queensland's budget

By Eva Brocklehurst

Copper

Risks are mounting for copper on the supply side in terms of outages, although prices are also being trampled by the US/China trade war. Macquarie is fielding investor queries as to what is required in terms of supply outage/reductions to overcome the increasing negative sentiment regarding global industrial activity.

The broker assesses copper is holding at US$5800/t but the impact of the US/China trade conflict on demand will need to now be factored in, as costs rise and business confidence takes a hit.

Supply remains weak and Chilean miners are talking of strikes, while grades are slipping. Zambia, meanwhile, appears to be repelling all future investment and the recently re-started Katanga asset in the Democratic Republic of the Congo is under review.

Furthermore, Macquarie adds, another scrap import restriction is increasingly likely in China as well. Supply-side disruptions need, at the very least, a neutral market tone in order to affect the price, the broker suggests. If the market is bearish, particularly amid global growth fears, incidents such as strikes will simply be ignored.

Steel

Macquarie notes a healthy demand for steel still seems to exist in China, as supply growth has been strong and exports subdued. Steel margins have, nevertheless, fallen to their lowest point in the year. Flat exports, when production is booming, generally suggest more domestic demand and/or rising stockpiles.

Macquarie observes China's property sector has clearly outperformed with investment rising at even higher rates than last year. Construction machinery, white goods and shipbuilding are also very active. However, the broader manufacturing sector in China is weak, particularly automotive industries.

How long can property drive apparent steel demand? As land purchases have fallen by nearly -34% in January-April, new building starts that are in evidence are more likely a lagged development, in the broker's view, rather than a reflection of positive sentiment and looser liquidity.

There is some offset from infrastructure, although Macquarie believes a peak is likely at the end of the September quarter or early in the December quarter. Steel inventory draw down has also begun to slow. Steel net exports only take 6-7% of China's steel production and exposure to the US is low. Hence, if it were not for property, China's steel demand would likely be slowing and this is bearish for prices and margins.

Citi expects stimulus measures globally will boost steel market sentiment and, with cash spreads now well below historical averages, there is potential for supply responses to emerge while Chinese exports trend down. Recent weak macro data and escalating trade war tensions have triggered stimulus efforts from central banks and governments globally.

Elsewhere, raw material costs have begun to ease. For the scrap producers, the broker expects new US and Chinese electric arc furnace (EAF) capacity will underpin scrap demand.

With steel profitability now below long-term averages, the broker believes the bottom of the market is near and upgrades Sims Metal Management ((SGM)) and BlueScope Steel ((BSL)) to Buy as the risk/reward turns favourable. The broker believes consensus downgrades are more than priced in for these two stocks.

Manganese

Manganese has performed poorly this year, Macquarie points out. Spot prices are now down -10-18% in the year to date. The broker notes the growth trend in imports to China has reversed in 2019, after constantly rising since 2017.

This appears odd, given very strong crude steel production rates. The explanations the broker offers are a surge in China's domestic manganese ore production (considered unlikely), de-stocking across the value chain or a drop in the intensity of use. On the latter, Macquarie notes a spectacular drop in vanadium, a sister product, which suggests a relaxation of the environmental standards that pushed usage of both metals higher last year.

On the supply front, South African export growth has slowed but there is still material coming from non-core suppliers which have contributed to a fall in seaborne prices. Macquarie observes the manganese ore industry lacks the supply constraints that have supported the prices of other bulk commodities

As the price declines, questions are being asked about the cost structure of the industry. Macquarie reiterates a mildly bearish view on manganese ore prices and expects more downside risk if the squeeze on upstream profitability continues amid plentiful stocks.

Iron Ore Miners

Citi notes the iron ore benchmark price is back over US$100/t as China's steel production has peaked and iron ore supply remains constrained. The broker finds China's steel mill margins are now very thin and supply of property is outstripping demand. Hence there is a genuine risk of steel production cuts in the second half of 2019, and the broker retains an iron ore forecast for 2020 of US$70/t.

Citi notes iron ore stocks are in the midst of a strong upgrade cycle, as estimates for both BHP Group ((BHP)) and Rio Tinto ((RIO)) have been revised up around 25% in the last three months. Consensus estimates for Fortescue Metals ((FMG)) have been revised up by around 100%. The broker notes, this upgrade cycle exists just for iron ore as, in way of contrast, earnings estimates for South32 ((S32)) are essentially unchanged over the period.

Rio Tinto has strong valuation support and Citi maintains a Buy rating. BHP is expected to generate a return on equity of 18% at a price of US$60/t for iron ore with net profit margin of 22%. Fortescue Metals can generate returns of 11% at US$60/t for iron ore for a net profit margin of 17%. The share price implies a long-run growth in earnings per share of 10.7% and Citi suggests the valuation metrics are becoming stretched.

Queensland Petroleum Royalties

Queensland's government budget paper has proposed increasing petroleum royalties to 12.5% from 10.0%, effective July 1. Ord Minnett notes, unsurprisingly, there has been a backlash from industry groups and LNG producers.

For the broker, the bigger issue centres on the flow-on effect that these costs would have on domestic gas and electricity prices on the east coast. Higher-cost gas supply from Queensland is increasingly setting spot domestic gas prices, as supply from traditional sources in Victoria decline.

Ord Minnett suggests the immediate effect of a direct hike in royalties would be reduced profitability from the east coast LNG plants: Australia Pacific LNG (APLNG), Queensland Curtis LNG (QCLNG) and Gladstone LNG (GLNG). All these have embarked on additional upstream drilling campaigns.

The state budget has also indicated there will be additional reviews into strengthening domestic supply through royalty regime settings, and simplifying the royalty regime more generally. The broker points out the former could raise the possibility of a different pricing regime for domestic gas, while the second has been more broadly welcomed.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

FNArena is proud about its track record and past achievements: Ten Years On

ESG Focus: Plastic – Not So Fantastic But Pretty Elastic (Part 2)

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

This article (part 1 & 2) is the first in a three-part series. It examines the global plastics context, the regulatory and tax landscape, the consumer and the ESG situation. The second article examines the core economic, technological and digital changes transforming the industry, such as recycling and competition from other substances. The third examines the plastics value chain, and which sectors and stocks will be hardest hit, and which are best placed to profit.

This story continues on from "Plastic – Not So Fantastic But Pretty Elastic", published as Part 1 on [date].

• Anti-plastic sentiment is building among consumers • The plastics industry is scrambling to pivot and is seeking R&D funding from existing waste levies and any new taxes • ESG investors have their sights on plastic – it's called blue investing - and it will have its greatest influence on capital intensive industries • Less capital-intensive industries such as packaging are expected to struggle

By Sarah Mills

Plastic Taxtics

Many governments are considering using the tax system as another lever: either taxing plastics, or introducing tax incentives for products with recycled content. This would have a significant impact on investor profits and industry viability.

France recently announced different tax rates based on the level of recycled or virgin plastic.

In the EU, the European Plastics Strategy states the Commission will "explore the feasibility of introducing measures of a fiscal nature at the EU level." Commissioner Gunther Oettinge, who is responsible for the budget, proposed a "national contribution calculated on the amount of non-recycled plastic packaging waste in each Member State", emphasising recycling over production cuts.

In a British report, Chancellor of the Exchequer Philip Hammond says the Treasury will explore "ideas to use tax to shift demand towards using recycled plastic in manufacturing, to encourage more sustainable design of plastic items and discourage those that prove difficult to recycle such as carbon black plastics, to reduce demand for commonly littered single use plastic items, including single-use coffee cups and takeaway boxes, and to ensure the right incentives are in place to encourage recycling of waste that is currently incinerated".

A Credit Suisse report says China's import restrictions have had a "colossal" impact on Australia and warns of an "impending plasticide". It has forecast that the Federal Government will introduce an emergency tax on virgin resin or unused and unprocessed plastic as early as next year – 2020.

If all else fails, there is always the least-favoured prospect of fines and jail terms for producers. In Kenya, anyone making, selling or importing plastic bags could face fines of up to $19,000 and four years in jail.

Path to a circular economy

There is no doubt that a tax on plastic production would be the most effective method of cutting waste. However, the plastic industry decries the use of taxes (and fines) as blunt tools, claiming taxes would kill off moves to recycle and create a circular economy.

Plastic companies are calling on governments to subsidise innovation and the necessary restructuring to move to a circular economy and recapture the $120bn lost to the economy in plastic waste each year.

In NSW, $720m in taxes goes into consolidated revenue through the waste levy. But to date, there has been little traction on subsidising such a shift globally, possibly because governments are focusing on dealing with the coal industry as a priority.

Plastic companies fighting uphill battle

The one clear message that comes from examining all of the above developments is that the plastics industry is unlikely to innovate faster than countries regulate.

The plastic industry is scrambling to prepare for the imminent tsunami of regulation. Since the bans were introduced, apart from a stellar lobbying response against changes, there appears to be a considerable mismatch between the industry's commitment and government expectations.

Plastics Europe, for example, published an alternative scheme to the EU setting a voluntary timeframe a full decade later than that of government. Cross-industry platforms to phase out certain products is occurring but it is a typical lobbying delay tactic and unlikely to be effective in this instance.

The industry is also working with municipal waste organisations around the world, and companies with deep pockets such as Coca-Cola are embarking on ambitious waste collection projects. Coca Cola has committed to collecting and recycling the equivalent of all its packaging by 2030. McDonald's claims that all of its packaging will come from sustainable sources by 2025.

Nearly 30 multinational companies have banded together to form the Alliance to End Plastic Waste, which plans to invest $1.5bn over five years to develop, deploy and bring to scale solutions that will minimise and manage plastic waste and promote post-use solutions. These will need to materialise if the industry is to avoid excoriation.

Plastics companies are also introducing lifecycle assessment tools to allow brands and consumers to determine which products have a better environmental footprint – plastic or alternatives – given paper substitutes, depending on their sourcing can also have environmental implications. However, the market may prefer independent assessment tools, given "the fox guarding the henhouse" risks.

Anti-plastic consumer sentiment building

Let's not forget the consumer. While typically consumers prefer to be regulated into action, there is a growing tide of anti-plastic sentiment. This is particularly dangerous for consumer goods companies that use plastic packaging, as it affects consumption of their core product. It may also threaten plastic companies' licence to operate.

In what is being described as the Attenborough Effect, a survey of 3,833 people by GlobalWebIndex shows that people in the US and UK reduced their use of single-use plastic by -53% in the past year. The survey shows 82% prefer sustainable packaging.

Citi believes that increased consumer and regulatory concern toward single-use plastic and other packaging materials is a critical investment theme, especially for asset managers with an ESG (Environmental, Social and Governance) mandate.

Plastic has a big future – recapturing value

Plastic is a multi-billion dollar industry representing 3% of the world's economy. It is critical to the functioning of some aspects of modern life, but certainly not the majority.

Despite the huge forecast disruption and regulation, worldwide plastic production is forecast to rise 3.8% every year until 2030, according to The Conversation and plastic production is forecast to double within 20 years according to the World Economic Forum. Similarly, the World Bank expects the quantity of waste and costs related to its treatment are likely to double by 2025.

The Ellen MacArthur Foundation estimates that $80bn to $120bn is lost to the economy every year – about 3m to 5m tonnes.

This value is set to be recaptured through recycling and other initiatives - that's $80bn to $120bn worth of opportunity every year for investors. Not since the disruption to the media industry have the stakes been so high.

Plastic turnover in Australia is approximately US$38.1bn turnover and the industry contributes $11bn to the economy, according to Springer Link. It is the second largest manufacturing sector with more than 50,000 direct employees.

It is this reach that is the industry's greatest defence. Many plastics may be unnecessary but few politicians have the political will to stomach the economic fall-out.

ESG investors to enter and alter the playing field

Another player on this field will be ESG investing. ESG investment stands at US$20trn or one-quarter of world investments.

It is already proving influential, particularly in industries that are capital intensive such as thermal coal and coking coal, which rely on investment to fund new projects, upgrades and refurbishments.

Plastic production tends to involve heavy industry at the refining, factory-scale polymerisation, and recycling stages of the value chain.

Cuffelinks identifies plastic as one of the top-10 global ESG issues and MSCI identifies plastic waste as one of five key ESG themes for 2019.

"How the world addresses the disruption it [plastic waste regulation] creates will have ripple effects across multiple industries and countries, ripping the issue from the pages of glossy sustainability reports and thrusting it into investor presentations and financial filings as a subject of business risks and opportunities," MSCI states.

Plastic has both an environmental and social component given the potential human health issues resulting from dumping and littering, which will attract the eyes of different investors, resulting in a broader array of solutions.

Calverts analysts estimate that 4% of the world's petroleum is used in the creation of plastics, and another 4% is used in providing the energy to produce plastic. This means the product has both a polluting and carbon profile, which will also attract the attention of different types of investors.

The littering problem is being targeted in a trend described as "blue investing", reflecting plastics' environmental devastation on the ocean. Many analysts and funds have specifically aligned themselves with the blue-investing theme.

According to analysts Sustainalytics, a coalition of 25 major institutional investors with combined assets valued at US$1trn have joined the Plastic Solutions Investor Alliance, declaring plastic pollution a corporate brand risk.

As the Calvert report states: "As the toxic effects of plastics are felt ocean-wide and beyond, investors can impact change by investing in strategies that assess a company's operator and the impact of its products and services on ocean health."

Given the vast majority of ocean plastic waste is derived from a handful of second and third-world countries with poor infrastructure, the success of any blue investing initiative will depend heavily on their investments in these countries.

To date, ESG investors with a carbon focus have bigger fish to fry (mainly coal) and plastics barely rate a mention in most climate-change oriented ESG reports. However, the polymerisation companies' expected transition to renewable energy is likely to attract some investment traction.

Disclosure net tightens for ESG

As is the case with the Sustainability Accounting Standards, disclosure is again being used as a tool to drive change.

The Plastic Disclosure Project, a Clinton Foundation Initiative, "encourages measurement and disclosure and management to improve corporate, community and individual accountability on plastic manufacture, use and disposal."

The Plastic Disclosure Project's analysis of 100 large listed consumer goods companies found that less than half reported quantitative data points about plastics. This is set to change, improving transparency for investment purposes.

The Plastic Disclosure Project clearly favours a circular economy over plastic bans. This means that much of the ESG funds will be channeled towards investment in recycling and other technologies, aimed at recapturing value, rather than withheld.

One of the key metrics will be transparency of material composition as this will make it easier for investors to know where to put funds and reduce risk of manufacturers sourcing sub-optimal products. This may prove a problem for recycling initiatives because large manufacturers often have to source plastic from many small suppliers. While virgin plastic is always standard, recycled plastic has greater potential for disparity, creating costly hiccoughs.

There have been some interesting initiatives aimed at attracting the ESG impact investing dollar. In 2017, for example, Apple issued a green bond to fund the research and development of recyclable material for its iPhones.

Recycling pretty much a no-brainer

While investing in recycling is generally a no-brainer for ESG investors, the problem for recyclers remains plastic's exposure to the oil price.

Fluctuations in the oil price can make massive differences to returns. Lower oil prices have recently hit the recycling market hard.

Unlike coal, where the blast furnaces are expensive to restart if uneconomical, polymisers regularly stop and start as part of their production of different grades of plastic.

This means that recycling won't have the same capacity to muscle out virgin plastic that renewables have enjoyed with coal, without some other kind of incentive or innovation. Investors will need to keep a keen eye out for taxes on virgin plastics, or regulations, that will permanently shift this balance and assure reliability of income.

There are also many as yet unproved initiatives popping up in new areas of finance, such as Plastic Bank, which enables the exchange of plastic for money, items or Blockchain-secured digital tokens. It is basically a plastics-recycling exchange, funded by an external currency. If successful, there is no reason why standard commodities exchanges could not add it to their offerings.

The disruption has barely begun. Expect further regulations, massive innovation, losses, and gains.

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

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

FNArena is proud about its track record and past achievements: Ten Years On

Weekly Ratings, Targets, Forecast Changes

By Rudi Filapek-Vandyck, Editor FNArena

Guide:

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

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

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

Summary

Period: Monday June 10 to Friday June 14, 2019 Total Upgrades: 3 Total Downgrades: 6 Net Ratings Breakdown: Buy 40.08%; Hold 43.42%; Sell 16.50%

Due to the close relationship between share price valuations and stockbroker ratings, it should be no surprise that as the local share market continues to power on, more downgrades than upgrades colour the overall activity among sell-side analysts.

For the week ending Friday, 14th June 2019, FNArena registered three upgrades for individual ASX-listed entities (of which two moved to Buy) against six downgrades.

As the background of the Australian share market's continued push higher is also coloured with profit warnings by operationally challenged domestic businesses, it should also not surprise the week's overview for amendments to valuations and price targets, and to earnings forecasts are equally skewed towards negative adjustments.

And so it is that the table for negative revisions to price targets is dominated by Star Entertainment (profit warning), Michael Hill (increased competition and pressure on household budgets) and Village Roadshow (boardroom upheaval and increased investment in lagging operations). Next one in the ranking sits a bruised AMP.

There is literally nothing to say about the positive side of the week's ledger, and this applies for earnings forecasts as well.

Some big moves in earnings forecasts occurred during the week on the back of a profit warning by Dacian Gold, followed by perennial disappointer Syrah Resources and a challenged AGL Energy. With Wesfarmers (profit warning), Star Entertainment equally receiving large negative reductions, followed by Orocobre, Aveo Group, and Village Roadshow.

Herein lays the dilemma for investors in Australian shares: are earnings estimates about to pick up soon, or will this rally remain in the hands of the RBA, and little else?

Upgrade

ALS LIMITED ((ALQ)) Upgrade to Hold from Sell by Deutsche Bank .B/H/S: 2/5/0

The FY19 result signalled growth was slowing in the minerals drilling business, which Deutsche Bank believes is indicative of an industry in the late stages of recovery.

Meanwhile, the life sciences business is considered attractive because of the recurring nature of services and structural growth. Deutsche Bank upgrades to Hold from Sell as the stock is now trading closer to the target of $6.57.

BLUESCOPE STEEL LIMITED ((BSL)) Upgrade to Buy from Neutral by Citi .B/H/S: 3/3/1

Citi notes the stock has pulled back substantially and sector sentiment remains weak amid falling steel/scrap prices and minimal buying interest. Still, the broker suspects a market nadir may be close.

Consensus downgrades are now largely priced in, and the broker points out the company's free cash flow yield remains over 10%, enabling a continuation of the $500m per annum share buyback. Citi upgrades to Buy from

Neutral and maintains its target of $14.

SIMS METAL MANAGEMENT LIMITED ((SGM)) Upgrade to Buy from Neutral by Citi .B/H/S: 4/2/1

Citi notes the stock has pulled back substantially and sector sentiment remains weak amid falling steel/scrap prices and minimal buying interest. Still, the broker suspects a market nadir may be close.

Given recent volatility and the sharp fall in scrap prices in the US, Citi reduces FY19 estimates by -5% and FY20-21 by -1%. A rising capital expenditure outlook reduces free cash flow but the company should be a beneficiary of improving scrap demand from expanded electric furnace capacity in the US.

Given a favourable risk/reward the rating is upgraded to Buy from Neutral. Target is steady at $11.50.

Downgrade

AMP LIMITED ((AMP)) Downgrade to Underweight from Equal-weight by Morgan Stanley .B/H/S: 0/5/2

While the stock has de-rated, Morgan Stanley believes the risk/reward indicates the valuation is not compelling and downgrades to Underweight from Equal-weight.

The broker believes it will take more than three years to re-model advice and the reshaping and strategic overhaul will consume capital released from the sale of the life business.

The broker suspects investors expecting a capital return will be disappointed. Target is reduced to $1.80 from $2.15. Industry view is In-Line.

HEALIUS LIMITED ((HLS)) Downgrade to Hold from Buy by Deutsche Bank .B/H/S: 2/4/0

Healius has made progress, Deutsche Bank observes, with some expansion in margins, increased GP billings and a high number of GP additions in the first half.

Still, the transformation program is in the early stages and the broker observes substantial work remains to be done on rolling out a new pathology LIS platform and refurbishing medical centres.

Deutsche Bank downgrades to Hold from Buy as the stock has moved above fundamental valuation. Target is $3.01.

MICHAEL HILL INTERNATIONAL LIMITED ((MHJ)) Downgrade to Hold from Add by Morgans .B/H/S: 3/1/0

A review of domestic fine jewellery store footprints has indicated heightened clearance activity. Morgans expects this to lead to further gross margin pressure in the near term.

Cost reductions remain on track and this should provide earnings support. Nevertheless, given the current industry conditions, Morgans downgrades to Hold from Add and reduces the target to $0.60 from $0.78.

The broker assesses competitor store closures can affect sales/margins meaningfully, albeit a longer-term revenue opportunity exists.

THE STAR ENTERTAINMENT GROUP LIMITED ((SGR)) Downgrade to Hold from Add by Morgans .B/H/S: 6/1/0

FY19 guidance for operating earnings (EBITDA) is weaker than Morgans expected. The company has highlighted the fact that domestic revenue growth has softened in the second half.

Given the uncertain outlook, Morgans downgrades to Hold from Add. Risks include the global economic environment affecting VIP activity, as well as a reduction in consumer spending and competition and regulatory changes. Target is lowered to $4.04 from $5.67.

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

Village Roadshow has provided a trading and strategy update and Macquarie has downgraded to Neutral in response. Turnaround momentum is evident but theme park and cinema earnings are expected to be similar to FY18 and FY20 looks like being a year of consolidation.

Target falls to $3.10 from $3.80.

WESFARMERS LIMITED ((WES)) Downgrade to Sell from Hold by Deutsche Bank .B/H/S: 0/3/3

Deutsche Bank observes, while the outlook has deteriorated for the company's discount department store earnings, the stock has still outperformed.

Some improvement may have occurred after the federal election, but the broker also believes weaker demand in housing categories is affecting Bunnings, compounded by cycling the past success of this key division.

Recent M&A activity also signals the portfolio is pivoting towards riskier assets with longer-dated return profiles. Hence, Deutsche Bank believes the current multiple is too high and downgrades to Sell from Hold. Target is reduced to $31 from $32.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 ALS LIMITED Neutral Sell Deutsche Bank 2 BLUESCOPE STEEL LIMITED Buy Neutral Citi 3 SIMS METAL MANAGEMENT LIMITED Buy Neutral Citi Downgrade 4 AMP LIMITED Sell Neutral Morgan Stanley 5 MICHAEL HILL INTERNATIONAL LIMITED Neutral Buy Morgans 6 THE STAR ENTERTAINMENT GROUP LIMITED Neutral Buy Morgans 7 VILLAGE ROADSHOW LIMITED Neutral Buy Macquarie Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 SGM SIMS METAL MANAGEMENT LIMITED 43.0% 29.0% 14.0% 7 2 ALQ ALS LIMITED 21.0% 7.0% 14.0% 7 3 BSL BLUESCOPE STEEL LIMITED 21.0% 7.0% 14.0% 7 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 MHJ MICHAEL HILL INTERNATIONAL LIMITED 75.0% 100.0% -25.0% 4 2 VRL VILLAGE ROADSHOW LIMITED 25.0% 50.0% -25.0% 4 3 AMP AMP LIMITED -29.0% -14.0% -15.0% 7 4 SGR THE STAR ENTERTAINMENT GROUP LIMITED 86.0% 100.0% -14.0% 7 5 WPL WOODSIDE PETROLEUM LIMITED 13.0% 25.0% -12.0% 8 6 JBH JB HI-FI LIMITED -13.0% -6.0% -7.0% 8 7 SUL SUPER RETAIL GROUP LIMITED 25.0% 31.0% -6.0% 8 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 JBH JB HI-FI LIMITED 24.615 24.365 1.03% 8 2 SUL SUPER RETAIL GROUP LIMITED 9.141 9.110 0.34% 8 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 SGR THE STAR ENTERTAINMENT GROUP LIMITED 4.856 5.553 -12.55% 7 2 MHJ MICHAEL HILL INTERNATIONAL LIMITED 0.693 0.753 -7.97% 4 3 VRL VILLAGE ROADSHOW LIMITED 3.418 3.605 -5.19% 4 4 AMP AMP LIMITED 2.124 2.174 -2.30% 7 5 WPL WOODSIDE PETROLEUM LIMITED 35.615 36.151 -1.48% 8 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 CSL CSL LIMITED 583.342 581.033 0.40% 8 2 MPL MEDIBANK PRIVATE LIMITED 15.986 15.929 0.36% 8 3 RIO RIO TINTO LIMITED 1004.121 1002.027 0.21% 8 4 QBE QBE INSURANCE GROUP LIMITED 87.924 87.741 0.21% 8 5 AWC ALUMINA LIMITED 25.533 25.480 0.21% 5 6 SDA SPEEDCAST INTERNATIONAL LIMITED 32.787 32.719 0.21% 4 7 FMG FORTESCUE METALS GROUP LTD 111.170 110.964 0.19% 8 8 S32 SOUTH32 LIMITED 32.186 32.130 0.17% 8 9 STO SANTOS LIMITED 57.506 57.407 0.17% 8 10 AQG ALACER GOLD CORP 32.606 32.559 0.14% 3 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 DCN DACIAN GOLD LIMITED -5.000 1.550 -422.58% 3 2 SYR SYRAH RESOURCES LIMITED -5.284 -4.151 -27.29% 5 3 AGL AGL ENERGY LIMITED 153.871 191.586 -19.69% 8 4 WES WESFARMERS LIMITED 175.029 217.300 -19.45% 7 5 SGR THE STAR ENTERTAINMENT GROUP LIMITED 24.840 28.335 -12.33% 7 6 ORE OROCOBRE LIMITED 9.133 9.703 -5.87% 8 7 AOG AVEO GROUP 12.067 12.733 -5.23% 3 8 VRL VILLAGE ROADSHOW LIMITED 11.133 11.733 -5.11% 4 9 WPL WOODSIDE PETROLEUM LIMITED 238.419 248.461 -4.04% 8 10 AMP AMP LIMITED 17.957 18.386 -2.33% 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.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

Uranium Week: Restart Setback

New regulations in Japan may see the few reactors that have restarted to date temporarily forced to shut down again.

-Tougher Japanese regulations -U3O8 spot price reacts -Global nuclear growth accelerates

By Greg Peel

In "news you don't want to hear", if you are a uranium producer or investor, last week the Japanese Nuclear Regulation Authority approved new rules that may force restarted reactors to temporarily shut down again.

As part of the initial restart approval process, which is centred on improved reactor safety in the wake of the Fukushima disaster, Japanese utilities agreed to construct back-up reactor control centres in offsite bunkers. At the time, the NRA was happy with guidance from utilities as to how long it would take to build the centres.

But now those utilities have admitted delays in construction. Kyushu Electric and Kansai Electric, for example, were to have completed their centres by next year but now both are suggesting a delay of one year. Other utilities have suggested up to a two-and-half year delay.

Under the new rules, the NRA can force reactors to again shut down if original deadlines are not met.

To date, only nine of Japan's 39 still-operable reactors have restarted in the eight years since Fukushima, having satisfied new safety requirements.

The spot uranium price had begun to again tick higher early last week until the news hit from Japan and sellers became more urgent. Despite the World Nuclear Fuel Market annual get-together being held in Lisbon during the week, which often leads to quiet trading, six transactions were recorded in the spot market totalling 700,000lbs U3O8 equivalent, industry consultant TradeTech reports.

TradeTech's weekly spot price indicator has fallen -US30c to US$24.30/lb.

TradeTech's term price indicators remain at US$27.35/lb (mid) and US$30.00/lb long.

Like for Like

BP's annual Statistical Review of World Energy, released last week, noted global nuclear power generation increased by 2.4% in 2018, mostly thanks to China, which is the fastest growth rate since 2010. BP forecasts nuclear power to continue to grow through to 2040, but at a slower pace than the total energy market.

Over in London, the CEO of Horizon Power told the Nuclear New Build conference that the UK should "replace nuclear with nuclear". Duncan Hawthorne noted nuclear had been a steady part of UK power generation for 40 years.

Hawthorne acknowledged the role renewable energy will contribute in the UK's energy future but suggested that while the nuclear industry does not seek to dominate the energy market, it would like to maintain the market share it has built.

Over to you Boris.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

FNArena is proud about its track record and past achievements: Ten Years On

The Short Report

Guide:

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

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

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

Summary:

Week ending June 13, 2019

As it transpires, I was correct to be sceptical about the data provided by ASIC which informed last week's Short Report. Last week's sea of green is suddenly a sea of red.

Last week only one stock moved up a bracket, implying a short position increase, while all other moves were downward, implying short-covering. This week only one stock went down (Metcash) while the rest went up.

Might as well be looking in a mirror. Even Amcor – the only stock I could offer a possible explanation for, is back in the table.

For the record, last week saw the ASX200 enjoy a sharp rally in line with Wall Street, as Trump's tariffs on Mexico were called off. The index then tracked sideways ahead of this week's rallies. We might assume such a sharp rally would lead to some frantic short-covering, except that the table below suggest the opposite.

Ignore the reds and greens on the table below, and likewise the table from last week. We now have to recalibrate and hope such data anomalies do not persist next week. Only then will we be able to assess what is really happening among short positions.

Weekly short positions as a percentage of market cap:

10%+

SYR 19.4 ING 17.0 NUF 16.2 JBH 15.5 NXT 14.5 GXY 14.1 ORE 13.8 BAL 13.2 BWX 12.5 BIN 11.5 IFL 10.3 DMP 10.2

In: IFL, BWX, BIN, DMP Out: MTS

9.0-9.9

PLS, SDA, MTS, RWC, SUL, HVN, BGA, PPT

In: SDA, RWC, PLS, PPT, BGA, MTS Out: BWX, BIN, DMP 8.0-8.9%

BKL, SGM, CSR, KGN, IVC, HUB, MYR

In: BKL, SGM, IVC, HUB Out: IFL, PPT

7.0-7.9%

WSA, CGC, CGF, BOQ, AMP

In: WSA, CGC Out: SDA, BGA, PLS, IVC, HUB, BKL

6.0-6.9%

NEC, GWA, GMA

In: NEC, GWA Out: RWC, SGM, CGC

5.0-5.9%

MSB, SEK, COE, MIN, RSG, A2M, SXY, OML, CTD, CLH, LNG, ELD, AMC, CLQ, MLX

In: RSG, A2M, OML, LNG, ELD, AMC, MLX Out: NEC

Movers & Shakers

Not today.

ASX20 Short Positions (%)

Code Last Week Week Before Code Last Week Week Before AMC 5.2 2.8 RIO 4.7 4.8 ANZ 0.7 0.7 S32 0.8 0.8 BHP 3.0 3.1 SCP 0.9 0.6 BXB 0.1 0.2 SUN 0.5 0.5 CBA 1.3 1.3 TCL 0.9 1.1 COL 1.5 1.3 TLS 0.6 0.5 CSL 0.3 0.3 WBC 1.5 1.7 IAG 0.5 0.3 WES 1.7 1.8 MQG 0.7 0.5 WOW 1.7 1.6 NAB 1.3 1.0 WPL 0.7 0.6 To see the full Short Report, please go to this link

IMPORTANT INFORMATION ABOUT THIS REPORT

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

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

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

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

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

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

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

FNArena has offered this qualified explanation of the vagaries of short stock positions as a warning to subscribers not to jump to any conclusions or to make investment decisions based solely on these unqualified numbers. FNArena

strongly suggests investors seek advice from their stock broker or financial adviser before acting upon any of the information provided herein.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

FNArena is proud about its track record and past achievements: Ten Years On

The Wrap: Wealth, A-REITs And Yield Stocks

Weekly Broker Wrap: wealth managers; IP services; A-REITs; Australian macro outlook; and yield stocks.

-AMP, IOOF need to reposition or risk continuing outflows, in Morgan Stanley's view -Volumes still appears solid in IP filings over 2019 to date -Coles' strategy a loser for shopping centres -Downside risk to market sentiment may be under-appreciated -Search for yield intensifying, a factor in the outperformance of the ASX 200

By Eva Brocklehurst

Wealth Managers

Morgan Stanley believes AMP ((AMP)) and IOOF ((IFL)) have no choice but to reposition their businesses or risk continuing outflows and declining margins. This is likely to take three or more years.

The broker assesses wealth managers need to rebuild a focus on customers and advice and simplify their offering. This comes amid new regulation which involves the elevated role of the trustee and heightened scrutiny of client best interests. There is also the impact of new technology and the digital, scaled advice solutions.

The broker downgrades AMP to Underweight and retains an Equal-weight rating for IOOF. The longer-dated nature of superannuation traditionally meant consumers were largely disengaged now, post the Royal Commission, this has changed and there is elevated switching, with industry funds the major beneficiaries.

IP Services

Bell Potter notes that in the five months to May 31, the number of patent applications filed with IP Australia was flat, albeit the previous May data was particularly strong. The number of directions issued for the period was up 30.9% and examination requests up 13.9%.

Overall, while growth in filings is muted, the broker still believes volumes are solid. Examination indicators also bode well for workflow in the next 12-24 months. The broker retains Buy ratings for IPH ((IPH)) and QANTM IP ((QIP)) and a Hold rating for Xenith IP ((XIP)), as the takeover offer from IPH appears reflected in the price.

A-REITs

The A-REIT sector has performed well this year, Macquarie observes, principally on the back of record low bond yields. However, within the sector there is divergence, and the broker assesses it will be difficult for retail A-REITs to rally against a backdrop of falling rents, rising capital expenditure and limited demand for shopping centres in direct markets.

The broker's preferences, therefore, lie with Goodman Group ((GMG)), Charter Hall ((CHC)), Lendlease Group ((LLC)) and Stockland ((SGP)). Additionally, Macquarie believes the strategy outlined by Coles Group ((COL)) is bearish for shopping centre owners. That company has made a conscious effort to slow growth in supermarket space and target refurbishments. There is also a focus on costs and improving the online offering.

Coles will tailor around 40% of store layouts towards the demographics of the area and focus on large format stores in greenfield growth corridors. Smaller infill stores below apartment towers will also be a focus. Hence, Macquarie asserts, the shopping centre as the key conduit between retailer and customer has ended, and this does not bode well for the segment.

Australian Macro Outlook

Morgan Stanley notes the ASX200 is up 18% so far in 2019 in local currency terms and 16% in US dollar terms. While the broker appreciates a shift in sentiment, recent data confirms challenges remain.

Several factors have combined to drive the upside and the broker counts lower tail risk, resulting from the Coalition victory in the federal election, and the stimulus from the Reserve Bank's reduction to official rates as key features of the rally in the index.

There is also regional rotation and the hunt for yield, both of which has brought a focus back to Australia. Iron ore leverage is also in play. Still, Morgan Stanley believes the downside risk to sentiment remains under-appreciated.

Yield Stocks

Ord Minnett notes the search for yield is intensifying, with global bond yields at or near all-time lows. The broker agrees this is particularly intense in Australia, where yields are among the highest in the developed world and this yield appeal has been an important factor in the year-to-date outperformance of the ASX200.

There is evidence of yield-seeking activity on the registers of major banks, where exchange-traded funds account for an increasing share, and the broker observes many high-yielding companies are now stretched on valuation grounds.

The broker's economists expect the Reserve Bank to cut the cash rate by a further -75 basis points by mid 2020, taking the terminal rate to 0.5%. This would drive further capital flows towards high-yielding sectors.

Ord Minnett flags stocks that represent a combination of attractive three-year average yields combined with a positive bottom-up view. These include Fortescue Metals ((FMG)), Vicinity Centres ((VCX)), Pendal Group ((PDL)), Woodside Petroleum ((WPL)), BHP Group ((BHP)), Stockland, GUD Holdings ((GUD)), ANZ Bank ((ANZ)) and Westpac Bank ((WBC)).

Major banks have recovered some ground in 2019, although have underperformed the index by around -300 basis points. Ord Minnett observes a short-term tactical appeal in the sector and prefers National Australia Bank ((NAB)), rated Accumulate.

Elevated iron ore prices are also supporting expectations for high short-term dividends from BHP Group, Fortescue Metals and Rio Tinto ((RIO)). The broker forecasts a declining dividend profile, while its three-year distribution estimates are well above the market. Yield spreads for resources and energy are noted to be the highest in the ASX200 index.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

FNArena is proud about its track record and past achievements: Ten Years On

Sale Puts Focus On Senex Energy's Gas Output

Brokers expect the sale of gas processing infrastructure at the company's Roma North field will strengthen Senex Energy's balance sheet, allowing the market to price in a greater portion of the future earnings profile.

-Tolling agreement covers an initial six PJ/annum at Roma North with options to expand -Senex Energy earnings less linked to oil as gas exposure increases -Queensland government increases onshore gas royalty to 12.5%

By Eva Brocklehurst

Senex Energy ((SXY)) will sell its gas processing infrastructure at the Roma North gas field to Jemena. The $50m sale and toll agreement strengthens the balance sheet and will allow the company to recycle capital into other projects.

Morgans believes it will remove any remaining funding concerns in the market as the company increases its drilling activity at Roma North and Project Atlas. The gas plant is in the final stages of construction and the tolling agreement covers an initial 6PJ/annum at Roma North, with the company holding an option to expand to around 9PJ/annum.

The company also has a provision for further expansion of the plant, which Morgans envisages is likely in the longer term. The broker expects the market will start to price in a greater portion of the future earnings profile as it obtains confidence around execution.

Credit Suisse agrees the sale will strengthen the balance sheet and make the company more resilient to lower oil prices. The broker now envisages Senex Energy as resistant to sub-$50/bbl oil prices under basic capital expenditure assumptions. There was some concern in the market about the need to raise capital but the broker assesses this is now unlikely and the sale and toll agreement should offset any concerns.

Morgans agrees, having never accepted a view that Senex Energy might require further funding, because a major debt package was obtained on favourable terms. A significant portion of near-term Cooper Basin production is also hedged at healthy prices. Morgans believes the market is undervaluing the organic earnings growth profile, as production from flagship projects steadily increases.

Earnings Outlook

The earnings profile starts to look particularly attractive from FY21 and Bell Potter calculates there is around $40-60m in capital left to spend of its FY19 guidance, estimating that, in FY20, the company will incur expenditure of $85m. Operating cash flows will provide additional cash offsets.

Credit Suisse upgrades to Outperform from Neutral on the back of the sale, partly offset by the risk of a higher royalty. While upgrading, the broker has made no change to the fundamental outlook. Rather, the decline in the share price following the drop in the oil price is considered overdone, particularly as Senex Energy earnings become less linked to oil from 2020 as its gas exposure increases.

Credit Suisse believes Senex management appreciates the east coast gas market opportunity better than most and will benefit from structurally higher prices from a portfolio of uncontracted gas. The main concerns centre on risks associated with the production ramp-up in the next 12 months and the sustainability of CSG production over the longer term.

The company has indicated it will be prioritising capital for longer-life gas developments over the higher-returning but shorter life oil production. Canaccord Genuity remains of the view that the market is being too harsh in its valuation of the Roma North asset. Moreover, with the Atlas Project production to be sold under fixed-price-plus-CPI arrangements, and a very strong hedge book, the broker believes the stock's relationship with oil should now be breaking down.

Morgan Stanley considers the transaction is designed to improve the balance sheet rather than be seen as a value-accretive deal. No actual toll was disclosed but the broker calculates, if Senex Energy were to pay around $1.50/GJ this would approximate $9m in annual fees to Jemena based on around 6PJ/annum. This is not likely to be paid all in one year as production rates are expected to build over time.

Queensland Royalty

The Queensland government has increased the onshore gas royalty to 12.5% from 10% effective from FY20. Credit Suisse models this as a negative impact of up to -5% on earnings, although notes the government has left room for exempting domestic gas usage. Hence, only half the impact is assumed in the valuation.

Canaccord Genuity tends to the view that changes, particularly with respect to domestic supply, could occur, although incorporates a 12.5% royalty into its valuation models. The broker, not one of the eight monitored daily on the FNArena database, has a Buy rating and $0.53 target.

Bell Potter, also not one of the eight, has a Buy rating and $0.47 target, supported by a positive outlook for the Australian east coast gas market and international energy markets more broadly. The broker expects significant earnings in free cash flow over the medium term for Senex Energy.

FNArena's database shows three Buy ratings and three Hold. The consensus target is $0.44, signalling 46.7% upside to the last share price.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

FNArena is proud about its track record and past achievements: Ten Years On

Tight Rental Market Enhances Emeco Holdings

Brokers have become favourably disposed towards Emeco Holdings, as the market for earthmoving equipment rental is tight after significant rationalisation of industry participants.

-Emeco Holdings at its most profitable since listing -Strong demand on Australia's east coast in coking coal -Miners increasingly restraining capital expenditure on equipment

By Eva Brocklehurst

Earthmoving equipment provider Emeco Holdings ((EHL)) continues from strength to strength, having simplified its business model to focus on the Australian mining rental market.

Brokers have become favourably disposed towards the stock, with the company's latest operating update inferring further earnings upside. Sector demand has improved and the equipment market is tight. This is characterised by expanding original equipment manufacturer order books and lead times.

The rationalisation of industry participants has also significantly improved the operating environment in earthmoving, Bell Potter points out. The company is now the most profitable it has been since listing and returns on capital and rental operating earnings (EBITDA) margins are at their highest levels since 2006.

Morgans also notes the company's report on Australian mining fleet deployment versus production levels shows the industry has extracted strong gains in the last five years without any material growth in fleet size. This is likely to have stemmed from mine site efficiencies, stretching the usage of existing equipment and tightening availability. Macquarie agrees the company is well-placed to leverage a diversified asset base amid industry conditions which remain favourable for heavy equipment leasing.

Bell Potter initiates coverage with a Buy rating and $2.63 target, noting the prospective earnings leverage to any increases in demand and estimating that a 100 basis points uplift in average operating utilisation has scope to yield between $1.4-2.4m in earnings.

An expansion in the rental fleet is expected to contribute around $25m to FY20 earnings and the company has guided to operating earnings of $211-213m for FY19. Moreover, free cash flow is expected to materially increase after an accelerated capital expenditure program in FY19.

The broker believes the current stock price is undemanding, particularly in light of the operating leverage within the rental business. The company has exited geographic regions outside of Australia and this provides a more sustainable earnings profile through the cycle.

Customers are predominantly mid or junior miners and mining contractors that have become averse to capital expenditure on equipment. This is particularly the case for marginal production increases, overburden stripping or short mine life projects. Miners are increasingly restraining capital expenditure and at the same time contemplating production expansion to serve growth in demand.

Hence, brokers consider the company well-placed for the transition to a production cycle in the resources sector. Management has lowered gearing levels and, combined with recent upgrades to the credit rating, this should provide options for refinancing senior notes, Bell Potter suggests.

The company will consider dividends and share buybacks after the notes are refinanced in March 2020, although continues to evaluate strategic acquisitions. The business has had, historically, a large presence in coal mining, reflected in strong growth in eastern Australia. Nevertheless, the business model is inherently flexible.

Coking coal is the major generator of revenue and demand is strong, while thermal coal exposure is less than 25% of total revenue. Emeco Holdings has also signalled there is no financial impact from recent negative developments in the gold sector in Western Australia.

Demand remains particularly strong on Australia's east coast in coking coal and while the west has been slightly softer over FY19, the company has flagged a significant increase in bidding activity. Macquarie expects early works with civil/mining contractors at new iron ore mines could provide upside risk to FY20/21 numbers and maintains an Outperform rating and $2.60 target.

Morgans expects modest 4-5% operating earnings growth in the base business is readily achievable as the company improves utilisation and cost efficiencies, calculating a 20% return on capital in FY19. The broker considers the stock oversold at current levels and retains an Add rating and $3.22 target.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

FNArena is proud about its track record and past achievements: Ten Years On

Treasure Chest: A Taste Of Freedom

Another broker initiates coverage of Freedom Foods with a Buy rating and a glowing outlook.

-Earnings disappointments forgiven -Investment in growth applauded -Nutritional focus met with strong demand

By Greg Peel

It's been a rocky road for Freedom Foods ((FNP)) to date in 2019, but after bottoming out in March following an earnings "miss" the share price has since rallied 26% from that low through a period which included a capital raising.

While earnings disappointed the market, a lot was down to the company's decision to exit a large number of low-margin manufacturing contract agreements in Cereals & Snacks. Forecasts were materially cut but brokers were undeterred, seeing the strategic move as minor disruption that would result in a better business over time.

Indeed brokers remained rather keen on the stock, attracted to the company's focus on Nutritionals.

Last month Freedom Foods announced another guidance downgrade, but this time it was accompanied by a $130m capital raising intended to fund growth in its nutritionals business.

The downgrade related to an upgrade to the company's UHT milk facility which had constrained production, and again brokers were circumspect. While acknowledging earnings growth would be limited in the near term period of investment ahead, analysts remained keen on the subsequent growth opportunity, particularly in high-value dairy ingredients.

The FNArena database of leading brokers shows three of the four who cover the stock on Buy ratings, with one Hold.

This week Goldman Sachs, not a database broker, initiated coverage of Freedom Foods with a Buy rating.

Freedom Foods is the biggest player in health food in the Australian supermarket channel, boasting the country's largest production capacity for UHT milk as well as strong positions in plant-based beverages and remaining cereal & snack brands. The company is now in the final stages of a $400m investment program focused on high-value, dairy-based nutritional products.

Goldman Sachs believes this investment will diversify the company's product and customer bases and increase exposure to high-growth categories and markets. Freedom Foods enjoys the competitive advantages of integrated supply, the latest technology at its purpose-built production facility and a proven track record, the broker notes.

Goldman sees the company benefiting from a global shift towards healthier lifestyles and functional foods, teamed with rising incomes in emerging markets. These trends should lead to strong demand for the nutritional products Freedom Foods is targeting.

Of course all roads lead ultimately to China, where the shortcomings of local products has led to a near hysterical demand for infant formula made from Australian and New Zealand milk, sending the share prices of listed producers downunder soaring over the past couple of years. Put "China" and "dairy" together and it seems one has an undeniable recipe for success, provided Beijing is onside with such a level of imports.

The Chinese government has not made things too easy, requiring certifications and providing other regulatory hurdles, with the so-called "daigou" market proving a source of disgruntlement. (Agents come to Australia and literally buy products off the shelf to take back to China.) But more recently Beijing has taken up more of a "don't fight them, join them" attitude in encouraging more cross-border collaboration, and to that end Freedom Foods has already established joint ventures and partnerships.

Goldman Sachs is forecasting a 44% compound annual growth rate in earnings per share in the period FY18 to FY21. The broker's $6.15 price target suggest 21% total shareholder return, hence a Buy rating.

This compares to an average $6.04 target set by the four FNArena database brokers covering the stock, implying 12% upside from the current trading price.

Note that Goldman's initiation had already helped to narrow that gap.

Collectively the database is forecasting 33% earnings growth in FY19 and 93% in FY20. At 1.0%, the forecast dividend is not the major attraction – this is a "growth" stock – but that is forecast to rise by 30% in FY20 (to 1.3%).

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

FNArena is proud about its track record and past achievements: Ten Years On

A Confirmation From Aussie Banks

In this week's Weekly Insights (published in two parts):

-A Confirmation From Aussie Banks -What's There To Worry? -Conviction Calls -Morphic Explains Shorts For CCL, Woolies -Rudi On Tour -Rudi Talks

[Non-highlighted parts will appear in Part Two on Friday]

By Rudi Filapek-Vandyck, Editor FNArena

A Confirmation From Aussie Banks

A pullback in most equity markets around the globe in May, while Australian equities continued to march onwards and upwards, have turned the Australian share market into one of the best performers all around in 2019.

But strategists and analysts are not so confident the local market can hold its own simply on the promise of more RBA rate cuts and, on the back of this, a potential recovery in domestic housing. Is the Australian share market now too expensive?

Let's find out whether my personal market indicator can shine any light on the issue.

Traditionally, I focus on share prices of the Big Four banks, and more specifically on the gap between these four share prices and FNArena's consensus price targets, to gauge the status for local sentiment in the share market.

Today, Tuesday 18th June 2019, Stock Analysis on the FNArena website shows CommBank ((CBA)) shares are trading well above target (to the tune of 13%), while Westpac ((WBC)) is also above target, as is ANZ Bank ((ANZ)), while the sector laggard National Australia Bank ((NAB)) still has a minor gap to fill (0.6%).

All else remaining equal, this seems to suggest investor sentiment is running red hot and there is not much room left, if any, to rally a lot higher from here, which shortens the odds for a pullback in the not too distant future.

The fact major commodity producers BHP Group ((BHP)) and Rio Tinto ((RIO)) are equally trading above their respective consensus target, while the next rally in both Woodside Petroleum ((WPL)) and Santos ((STO)) will put the major energy producers in the same position, only reinforces the idea that the local share market is trying to defy gravity in June.

Hence, in the short term, my banking stocks sentiment indicator confirms it's probably best to be a little more cautious for investors.

****

When using this market indicator, and every other gauge I hasten to add, investors should always question whether there are specific circumstances that can potentially make its apparent signal invalid. This is not always easy and one of the key reasons my advice to investors is to never rely on just one indicator or signal.

In this particular case, there are times when banks share prices are dominated by sector-specific dynamics that are not necessarily representative for the Australian economy or share market as a whole. Think last year's Royal Commission, for instance. It goes without saying during such times whatever happens to bank share prices cannot be used to measure risk appetite in general.

Which begs the question: are we back to normal?

I suspect the answer is yes. See BHP and Rio Tinto above. A number of other indicators is equally suggesting more upside might just be a stretch too far, and not long lasting given the ongoing declining trend in earnings forecasts outside of iron ore producers in Australia.

This need not be the end of the road for the local share market. After all, share markets are forward looking and in less than two months we'll have the August reporting season to take note and update our general outlook for the year ahead.

One of the key reasons as to why Australian bank shares have recovered so swiftly this year is because investors can once again see profit growth on the horizon, after having succumbed to the view there won't be any growth for

longer for the sector.

****

This change in outlook explains the upgrade CommBank received from Bell Potter this week.

Apart from lifting the rating to Buy from Hold, Bell Potter's price target for the year ahead lifted to $86 from $80 essentially on the belief CBA's Net Interest Margin (NIM) will prove resilient (no meaningful further decline) and dividends look even more solid, expected to remain at 431c per annum for years to follow (for a yield of circa 5.4% ex-franking)..

Now, I agree, one swallow does not a summer make and to date not one of the eight stockbrokers monitored daily by FNArena has set a target that comes even near Bell Potter's, but the update illustrates the changed market perception towards the sector, and what is likely to follow next.

Note also, Bell Potter's updated forecasts are not assuming CommBank is about to grow cash EPS by double digit percentage again, as in the pre-GFC golden era for the sector.

It is simply based upon the assumption that negative or no growth will be replaced by some growth. Little things can have a significant impact in the share market and this is one such example.

****

Some commentators elsewhere have suggested one key driver for the strong performance in bank share prices has been short covering following the surprise outcome in the federal election in May, which seems but plausible, but certainly not the full picture.

Other factors in play include:

-local funds managers lifting their portfolio exposures to banks, having been underweight the sector for a long time

-cash rate cut by the RBA with firm hints the bias remains in favour of more cuts, fueling expectations the local housing market down-cycle might be near its trough and things should brighten for housing related activity, consumer spending and the Australian economy in general

-the rally in government bonds globally has once again ignited a search for yield and large cap stocks in Australia, banks in particular, quickly landed on foreign investors' buy list

-a rising realisation the Aussie dollar is most likely to weaken, which makes owning Australian shares extra-attractive for foreign investors

Last but not necessarily least, I also suspect Labor's failed election campaign has highlighted dividend yields and franking among retirees and pensioners across the country, creating an extra source of demand post Coalition re-election.

****

There are more shades of grey in this than I can possibly sum up here, but most question marks that surround banking shares today equally apply to the broader Australian share market: will the RBA deliver, and will it have the anticipated impact? Is the government otherwise ready and prepared to join in?

As such, and with obvious nuances, the outlook for shares in Lendlease ((LLC)), Stockland ((SGP)), GUD Holdings ((GUD)), FlexiGroup ((FXL)), Accent Group ((AX1)) and others shall remain closely intertwined with the outlook for Australian banks.

As such, I think we can safely say the banks are back in their traditional role as a general indicator for momentum and health in the Australian economy; they also look valuation-stretched in the immediate term.

What's There To Worry?

One of the oddest observations I came across in the week past is the fact that, according to Citi's Panic-Euphoria indicator, global investor sentiment is now near Panic while one would have thought fully blossoming Euphoria seems more likely, in particular with Australian indices closing in, finally, on their pre-GFC all-time high.

While I have no deeper insights into the methodology behind Citi's indicator, I do know over the past two decades or so (most likely much longer), determining whether global sentiment reflected "Euphoria" or "Panic" has been quite reliable at turnaround points for equities either way.

Usually, when sentiment gets so bad that "Panic" applies, investors are best off by putting money into equities, as was the case late last year and in early 2016, and when the indicator is showing sentiment has ventured deeply into Euphoria, it's time to start worrying about potential downside, as was the case in late 2017 and again in 2018.

Historically, Panic appears when shares are down and Euphoria tends to show up when equities are rallying, so what is different this time?

I suspect what makes this time different is that the global investment community has remained overwhelmingly cautious in the face of USA-China tension, as well as the need for central banks to again provide support for deflating economic momentum and the staunch resistance in price inflation to finally become a positive problem.

As such, money has kept flowing into government bonds and into defensive assets in share markets. Witness, for example, how sectors healthcare, telecommunication and industrials in Australia have been among the best performers this year. The latter sector includes stocks like Sydney Airport and Transurban, usually aligned with a more cautious investment approach, at least when bond yields are not the driving force.

And that latter point might be essential for understanding why Citi's indicator is flashing "Panic" rather than "Euphoria"; equity markets have risen on the "bad news is good news" mantra, and this is reflected in global funds flows having mostly preferred the safety of bonds and the luxury of bond proxies in the share market.

Time to highlight what I believe are the key risks/question marks for equity markets, as these will be on the minds of professional asset managers the world around.

In the US, forward indicators continue flashing weakness lays ahead. The leading indicator from the OECD is a case in point.

Globally, momentum remains negative, including for the US economy with the OECD leading indicator for the number one economy in the world now showing a negative reading of -1.6% year-on-year; its worst reading since August 2009.

This suggests momentum was already losing its oomph well before tensions rose firmly between China and Washington. An outbreak in hostilities, or even a continuation of the current impasse are only adding to the weakening outlook.

Thus far US markets have remained remarkably resilient, with many a commentator suggesting investors simply refuse to believe there won't be an agreement, in some form, between the two protagonists, at some point.

Maybe.

I think a lot of confidence also rides on the back of the Federal Reserve possibly reversing back into stimulus mode through renewed interest rate cuts.

If everything goes according to plan, the US economy and corporate profits in America are facing two weak quarters ahead, but by the final quarter of 2019 momentum for both is expected to accelerate noticeably.

I remain of the view that as long as this prospect remains alive, and many believe it remains feasible enough to rely upon, equity markets can remain firmer for longer - but watch out if confidence falters.

In Australia, the situation is slightly different. The RBA is cutting the cash rate, while others such as APRA are trying to loosen financial conditions on top of these cuts.

RBA Governor Philip Lowe is communicating at the best of his abilities that interest rates will be lower in the months ahead. Economists are now fiercely debating how low the domestic cash rate might go.

Is the RBA going to stop at 1% (one more cut)? Will it be 0.75% (two more cuts)? Or is 0.50% the bottom (three more cuts)?

Irrespective, while equities gain on the initial support from central bank cash rate reductions, the support for housing related sectors and consumer spending has to show up in concrete numbers at some point, or sentiment will turn negative.

While this is a tangible risk when indices are posting post-GFC highs and approaching the all-time peak from late 2007, it seems too early to bicker about the effectiveness of a lower RBA cash rate just yet.

The RBA is going to cut its cash rate further. The minutes released on Tuesday repeated that message unambiguously. For now, that's all the local market wants to hear and read.

The April update for the OECD leading indicators also suggests the downturn in economic momentum in few countries including China and Australia might be stalling, which makes for yet another data input to remain optimistic about what awaits on the medium-term horizon.

Rudi Talks

Audio interview on Wednesday about what is happening in the share market:

https://www.youtube.com/watch?v=p1jk7peGbns&feature=youtu.be

On Monday I participated in Episode 5 of Switzer TV (I appear 8 minutes in for about 10 minutes):

https://www.youtube.com/watch?v=4VHWkPpSlc0

Rudi On Tour In 2019

-AIA National Conference, Gold Coast, Qld, 28-31 July -AIA and ASA, Perth, WA, October 1

(This story was written on Monday and Tuesday 17-18th June 2019. It was published on the day in the form of an email to paying subscribers, and again on Thursday as a story on the website. Part two follows on Friday).

(Do note that, in line with all my analyses, appearances and presentations, all of the above names and calculations are provided for educational purposes only. Investors should always consult with their licensed investment advisor first, before making any decisions. All views are mine and not by association FNArena's - see disclaimer on the website.

In addition, since FNArena runs a Model Portfolio based upon my research on All-Weather Performers it is more than likely that stocks mentioned are included in this Model Portfolio. For all questions about this: info@fnarena.com or via the direct messaging system on the website).

****

BONUS PUBLICATIONS FOR FNARENA SUBSCRIBERS

Paid subscribers to FNArena (6 and 12 mnths) receive several bonus publications, at no extra cost, including:

- The AUD and the Australian Share Market (which stocks benefit from a weaker AUD, and which ones don't?) - Make Risk Your Friend. Finding All-Weather Performers, January 2013 (The rationale behind investing in stocks that perform irrespective of the overall investment climate) - Make Risk Your Friend. Finding All-Weather Performers, December 2014 (The follow-up that accounts for an ever changing world and updated stock selection) - Change. Investing in a Low Growth World. eBook that sells through Amazon and other channels. Tackles the main issues impacting on investment strategies today and the world of tomorrow. - Who's Afraid Of The Big Bad Bear? eBook and Book (print) available through Amazon and other channels. Your chance to relive 2016, and become a wiser investor along the way.

Subscriptions cost $420 (incl GST) for twelve months or $235 for six and can be purchased here (depending on your status, a subscription to FNArena might be tax deductible): http://www.fnarena.com/index2.cfm?type=dsp_signup

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

Rudi's View: Banks, Bapcor, And Woolworths

In this week's Weekly Insights (this is Part Two):

-A Confirmation From Aussie Banks -What's There To Worry? -Conviction Calls -Morphic Explains Shorts For CCL, Woolies -Rudi On Tour -Rudi Talks

[Non-highlighted parts appeared in Part One on Thursday]

By Rudi Filapek-Vandyck, Editor FNArena

Conviction Calls

Differences in views and opinions are what maketh the share market, or so the adage goes and post UK/Brexit-inspired profit warning this has also become apparent in views about Link Administration ((LNK)).

Whereas the Morningstar Model Income Equity Portfolio has now used some of its excess cash to add shares in Link Administration on the expectation that risks and bad news have been priced in and there should be improvement on the horizon, portfolio managers at stockbroker Morgans beg to differ; they sold out of the stock because risks are considered too high, and the outlook may just disappoint a while longer.

In Australia, Morningstar suggests industry super funds gaining market share will play to Link's benefit, but Morgans sees earnings pressure continuing because of regulatory changes to super.

Morgans' Growth Model Portfolio did top up its holding in OZ Minerals ((OZL)) seeing the sizable share price fall since early April as a buying opportunity. Over at Wilsons Advisory and Stockbroking, yet another profit warning from The Star Entertainment Group ((SGR)) proved one too many.

Wilsons Australian Equities (Income) fund has sold out of Star Entertainment, ignoring the apparent value on offer post share price shellacking, instead focusing on "increased uncertainty around the earnings base of the business".

At the same time, holdings in ANZ Bank ((ANZ)) and CommBank ((CBA)) have been increased to push the portfolio's exposure to Australian banks to Marketweight, while keeping the financials sector as a whole on Overweight.

****

Returning to Morningstar, its Best Stock Ideas recently added Bapcor ((BAP)) and removed oOh!media ((OML)).

The other eight stocks remaining in the selective list are Domino's Pizza ((DMP)), Iluka Resources ((ILU)), Link Administration (see also above), Nufarm ((NUF)), Pact Group Holdings ((PGH)), Telstra ((TLS)), Westpac ((WBC)), and Woodside Petroleum ((WPL)).

The FNArena Vested Equities All-Weather Model Portfolio owns shares in both Link Administration and Bapcor.

Morphic Explains Shorts For CCL, Woolies

It's a burgeoning industry, still, albeit incredibly fast growing and with increasing impact. Already there is a plethora in approaches, strategies and styles available for investors who like to see their money invested in non-traditional manner.

One of the better known domestic managers using responsible investment filters before selecting and researching stocks is Morphic Asset Management, soon to be acquired by Ellerston Capital. Morphic also provided the rough overview in styles below.

What makes Morphic unique in its style of responsible investing is that it can not own any companies that fail at the first hurdle of stringent ESG filters applied, but it can go short such companies. The fund managers explained during the recent investor tour their reasons for being short Woolworths ((WOW)) and Coca-Cola Amatil ((CCL)).

When funds managers like Morphic go short on a stock they are trying to benefit from a weaker share price at some point into the future.

While taking a short position on an ASX-listed stocks is not at every investor's disposal (I have never gone short on any stock myself), I suspect either or both stocks might be included in many portfolios, which is why investors may

want to take notice.

Supermarket owner and liquor distributor Woolworths fails the ESG filter dismally at Morphic. Not only is Woolworths one of the largest owners of pokies in Australia, through its partial ownership of pubs and clubs, but the group is also one of the largest sellers of alcohol in the country given it owns and operates BWS and Dan Murphy's.

Morphic's negative view is above all inspired by a business model that is increasingly under pressure, while the stock's valuation is approaching the heady highs from pre-GFC days.

More German supermarkets entering the Australian landscape in 2020 cannot be a good thing for sales and margins, so goes the thinking, while changing shopping patterns are keeping the pressure on Big W and, increasingly, the liquor chains.

Woolworths' growth next year is predominantly based upon an improving picture at Big W, but Morphic clearly doesn't think of it as longer term sustainable.

Bottom line: Woolworths' EPS is today roughly equal to where it was ten years ago, but its valuation is again riding a peak in investor sentiment. Morphic thinks the future most likely involves a weaker share price, and is therefore positioned short.

Shares in Woolworths entered calendar 2019 around $29 and surged to near $35 in May, after which they settled around $32.

The negative view on Coca-Cola Amatil is even more intriguing, with Morphic identifying ESG negatives in fizzy drinks, alcohol, plastic waste and sugar.

Valuation is again considered too rich in light of the ongoing operational challenges and the long term decline for key products in key markets for the company.

Most importantly, the managers at Morphic are suspicious of the company's real growth rates in key countries New Zealand and Indonesia. They believe the company has failed to address their concerns when questions had been asked about a change in geographic reporting.

Coca-Cola Amatil now reports on the basis that New Zealand and Fiji combined are one region, while Indonesia and Papua New Guinea are also grouped together into one reporting region. It is Morphic's suspicion this is because Fiji and PNG are fast growing still, while New Zealand and Indonesia are likely not, or possibly not much growing at all.

Here the suspicion is that the chosen regional groups are designed to mask the lack of underlying growth in two key regions for the company.

As far as Morphic is concerned, this should ring alarm bells across the wider investment community (which it clearly is not to date judging from the share price), hence why the managers are positioned short Coca-Cola Amatil.

Investors should note Morphic has been short Coca-Cola Amatil shares in the past, and with rather mixed results.

Coca-Cola Amatil shares have rallied strongly in 2019 after bottoming around $8 in the first quarter, surpassing $10 in June.

Rudi Talks

Audio interview on Wednesday about what is happening in the share market:

https://www.youtube.com/watch?v=p1jk7peGbns&feature=youtu.be

On Monday I participated in Episode 5 of Switzer TV (I appear 8 minutes in for about 10 minutes):

https://www.youtube.com/watch?v=4VHWkPpSlc0

Rudi On Tour In 2019

-AIA National Conference, Gold Coast, Qld, 28-31 July -AIA and ASA, Perth, WA, October 1

(This story was written on Monday and Tuesday 17-18th June 2019. It was published on the day in the form of an email to paying subscribers, and again on Thursday as a story on the website. This is Part two).

(Do note that, in line with all my analyses, appearances and presentations, all of the above names and calculations are provided for educational purposes only. Investors should always consult with their licensed investment advisor first, before making any decisions. All views are mine and not by association FNArena's - see disclaimer on the website.

In addition, since FNArena runs a Model Portfolio based upon my research on All-Weather Performers it is more than likely that stocks mentioned are included in this Model Portfolio. For all questions about this: info@fnarena.com or via the direct messaging system on the website).

****

BONUS PUBLICATIONS FOR FNARENA SUBSCRIBERS

Paid subscribers to FNArena (6 and 12 mnths) receive several bonus publications, at no extra cost, including:

- The AUD and the Australian Share Market (which stocks benefit from a weaker AUD, and which ones don't?) - Make Risk Your Friend. Finding All-Weather Performers, January 2013 (The rationale behind investing in stocks that perform irrespective of the overall investment climate) - Make Risk Your Friend. Finding All-Weather Performers, December 2014 (The follow-up that accounts for an ever changing world and updated stock selection) - Change. Investing in a Low Growth World. eBook that sells through Amazon and other channels. Tackles the main issues impacting on investment strategies today and the world of tomorrow. - Who's Afraid Of The Big Bad Bear? eBook and Book (print) available through Amazon and other channels. Your chance to relive 2016, and become a wiser investor along the way.

Subscriptions cost $420 (incl GST) for twelve months or $235 for six and can be purchased here (depending on your status, a subscription to FNArena might be tax deductible): http://www.fnarena.com/index2.cfm?type=dsp_signup

P.S. I - All paying members at FNArena are being reminded they can set an email alert for my Rudi's View stories. Go to My Alerts (top bar of the website) and tick the box in front of 'Rudi's View'. You will receive an email alert every time a new Rudi's View story has been published on the website.

P.S. II - 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.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

FNArena is proud about its track record and past achievements: Ten Years On

TERMS AND CONDITIONS OF USE, AND DISCLAIMERS

These Terms and Conditions of Use, and Disclaimers constitutes your agreement with News Network with respect to your use of its FN Arena website, its weekday news periodical, Australian Broker Call, as well as it's monthly periodical Australian Super Stock Report, as well as any other publications (including articles) News Network may publish on its website, or anywhere else, from time to time. Please read the contents of this page carefully as it contains important legal information and disclaimers. By entering and perusing the website, reading the Australian Broker Call or the Australian Super Stock Report, or, if you are subscriber, by entering the password protected part of the website, you acknowledge that you have read, understood and accept this agreement.

By accepting this agreement you acknowledge, understand and accept the following:

1. Reference to "FN Arena" and "News Network" means reference to News Network Ltd, its journalists, directors, other employees, affiliates, agents, associates and subsidiaries.

2. News Network Ltd is the owner of the FN Arena website and brand name.

3. Reference to "we" or "us" is reference to News Network.

4. Reference to "this website" or the "FN Arena website" means reference to www.fnarena.com, and includes reference to News Network's weekday news periodical, Australian Broker Call, as well as its monthly periodical Australian Super Stock Report, as well as any other publications (including articles) News Network may publish on this website, or anywhere else, from time to time.

5. Reference to "news periodicals" means reference to News Network's weekday periodical, Australian Broker Call, as well as it's monthly periodical Australian Super Stock Report, as well as any other periodicals News Network may publish from time to time on this website, or anywhere else, from time to time.

6. Reference to "publications" in this agreement means any material, including articles, published or put in print on the FNArena website, or anywhere else, whatsoever, and includes News Network's weekday periodical, Australian Broker Call, as well as it's monthly periodical Australian Super Stock Report, and any other periodicals News Network may publish from time to time.

7. Reference to a "visitor" means, you, a visitor to this website, and includes a subscriber to Australian Broker Call and the Australian Super Stock Report, as well as any other publications or periodicals News Network may, from time to time, publish on this website.

8. News Network is a media company which employs financial journalists to report financial news. News Network's journalists perform the required research and collect the information that is, ultimately, each day, published on this website and in News Network's news periodicals. As is obvious, the process by which the information is collected and delivered to you is a purely journalistic one and, therefore, the comments, opinions and recommendations News Network reports on this website are not the opinions of News Network or any of its journalist or other employees. News Network is ONLY and specifically a matter-of-fact reporter of industry signals suggesting price direction probability of some shares. News Network simply delivers the information – it does not create it.

9. Although News Network obtains the information published herein from sources deemed to be reliable, and given and received in good faith, it cannot and does not guarantee its accuracy. News Network does not take any responsibility either for the financial soundness or for the correctness of statement made or opinion expressed in the data or content reported by News Network, and cannot and does not guarantee the reliability and accuracy of the opinions of the brokers whose opinions, recommendations and forecasts it reports.

10. News Network publishes this website, all publications and its periodicals strictly for convenient personal, non-commercial, educational and informational purposes of its subscribers only. Our goal is to provide the subscribers with a convenient starting point of potentially useful, but not comprehensive, content that can educate or otherwise enhance a visitor's knowledge base and frame of reference.

11. News Network is NOT a stock broker or financial or trading advisor, nor is it an advisory service of any kind, and no advice or recommendations on investments or trading are made nor implied on this website. Nothing contained in this website is intended to be, nor shall it be construed as, advice or recommendation. Any investment or other decisions made by you must be based solely on your own evaluation of the targeted subject for investment, and your financial circumstances and investment objectives, and News Network will not be held liable for any such investments and decisions.

12. It is distinctly understood and accepted that the shares referred to in the FN Arena website, News Network's publications and/or periodicals have not been recommended by News Network. The content and or any comments found of this website, including the content and/or comments published in any publication and/or periodicals published by News Network, do not constitute a recommendation or endorsement by News Network with respect to any company, security, share or investment or any financial or investment product.

13. This website makes no representations, and, to the extent allowed by the law, specifically disclaims all warranties, express, implied or statutory, regarding the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any material contained in the website.

14. Before making an investment decision, you must do your own research and rely on your own examination of the share, and the risk involved, and not on what you read on the FN Arena website, or in any publication or periodical. The content of this website is provided strictly for convenient personal, non-commercial educational and informational purposes only and News Network shall not be held liable for any investment decisions, sales or purchase decisions, which you may have made based on what you have read on this website or in the periodicals published by News Network from time to time, or in any other publications News Network may publish on its website, or anywhere else, from time to time. Anyone who makes investment decisions based on what they read on this website does so at their own risk, and agrees that they cannot hold News Network responsible and/or liable for any loss whatsoever.

15. It is your responsibility to evaluate the completeness, accuracy and usefulness of any content made available on this website. If you are unsure, or in doubt about the meaning of any information, you should consult your financial advisor.

16. News Network does not guarantee any returns on investments made in any share mentioned on this website by the visitors. As any investor well knows, any investment opportunity, strategy or concept involves a degree of risk and investors should not invest any funds unless they can afford to take the risk of losing their investment. News Network strongly suggests that you consult your own financial advisors regarding the soundness of any intended investments, strategies or concepts, and discuss with such advisor your individual investment needs and goals. You may also wish to consult the broker who expressed the opinion we have reported on in the news periodicals we publish.

17. News Network shall not be held liable to any visitor of the FN Arena website, or any reader of its periodicals and/or publications, or anyone else who may have relied on this website, directly or indirectly, for any inaccuracies in the printed material found on the FN Arena website, in the periodicals and/or other publications, any typing errors, omissions, interruptions, timeliness, completeness, deletions, defects, failure of performance, computer virus, communication line failures, alterations of, or use of any content herein, regardless of cause, for any loss or damage resulting therefrom.

18. Under no circumstances, including, but not limited to negligence, shall News Network be liable for any direct, indirect, incidental, special or consequential damages that result from the use of, or the inability to use, the FN Arena website, and any or the News Network's publications and/or periodicals.

19. As a condition of use of the FN Arena Website, News Network's publications and periodicals, you agree to indemnify News Network and all those affiliated with it from and against any and all liabilities, expenses (including legal costs) and damages arising out of claims resulting from your use of the FN Arena website, News Network's publications and periodicals. If you are uncertain about this agreement or the contents of the FN Arena's website, or are dissatisfied in any shape or from, with the content of the FN Arena website, or any of the publications or periodicals, or you do not agree with these terms and conditions, your sole and exclusive remedy is to discontinue using the FN Arena website, News Network's publications and periodicals.

20. News Network may, from time to time, publish advice, opinions and statements of various third parties, other then the ten stock brokers, and various other information and content providers. News Network does not represent or endorse the accuracy or reliability of any advice, opinion, statement or other information provided by these third parties. Reliance upon any such opinion, advice, statement, or other information is at your own risk.

21. The FN Arena website may contain links and pointers to websites maintained by third parties. News Network does not operate or control in any respect any information, products or services on such third-party websites. Third party links are included solely for the convenience of visitors, and do not constitute any endorsement by News Network of any products or services provided by the third party link owners or operators. News Network has no control over any websites that we might link to and does not take responsibility for their quality, content or suitability.

22. News Network is not responsible for claims made by advertisers on the FN Arena website or in any of its periodicals. Such advertisements are included solely for the convenience of visitors, and do not constitute any endorsement by News Network of any products or services advertised. News Network does not check the accuracy of the statements made by the advertisers. You assume sole responsibility for the access and use of third party links and pointers from the FN Arena website, as well as any purchases you may make from those third parties (including advertisers).

23. All the content, information and material made available on this website are provided to you "as is" and without warranty of any kind from News Network whether express or implied, including, but not limited to, implied warranties of merchantability and fitness for a particular purpose, title, non-infringement, security or accuracy, nor does News Network endorse or take any responsibility for the accuracy or reliability of any opinion, advise or statement made through the FN Arena website, its periodicals, or for making good all or part of any loss and/or damage that may have been caused by the visitor's reliance on any information, advise, product or service obtained from a linked website.

24. News Network is not liable for any copyright infringements incurred by any outside content or information contributors, or by third parties who have links to this website, or advertise on this website.

25. News Network reserves the right to make any and all changes to the FN Arena website, including the publications and periodicals, at its sole discretion without notice to you. News Network reserves the right to deny access to this website or its information to anyone at any time.

26. This agreement shall be deemed to include all other notices, policies, disclaimers, and other terms contained in the FN Arena website, provided, however, that in the event of a conflict between such other terms and the terms of this agreement, the terms of this agreement shall prevail.

27. News Network shall have the right, at its discretion, to change, modify, add or remove terms of this agreement at any time. Changes shall be effective immediately. Notification of any such changes shall be made herein, therefore, you are strongly advised to read these terms each time you wish to access the FN Arena website or any periodical.

28. No permission is granted to copy, distribute, modify, post or frame any text, graphics, video, audio, software code, or viewer interface design or logos. The entire FN Arena website, including the publications and periodicals, is subject to copyright with all rights reserved. The information contained in the website, including the publications and periodicals, shall not be published, rewritten for broadcast or publication or redistributed in any medium, or for any other reason whatsoever, without prior written permission from News Network.

29. All original content is the copyrighted property of News Network.

FN arena
PASSIONATE ABOUT FINANCIAL NEWS

Financial News for the Bright and the Uneducated. And for everybody else in between.

FN Arena News
Building the Future of Financial Journalism

www.fnarena.com

Trials are free and without any obligation