Week
3

Stories To Read From FNArena

Friday, 18 January 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

Contents

Australia

Commodities

FYI

Weekly Analysis

Treasury Wine Outlook Cheers Brokers

Treasury Wine Estates has flagged strong earnings growth for 2019, although several brokers remain concerned about the softer US wine business signalled by competitor, Constellation Brands.

-Wine demand seen strong in China despite soft Oz export data -US focus on higher retail price points a positive read for Treasury Wine -2019 US margins likely to expand as distribution changes are incorporated

By Eva Brocklehurst

Treasury Wine Estates ((TWE)) has raised a glass to the New Year, cheering most brokers with a positive outlook. The company has guided to first half operating earnings (EBITS) of $335-340m. Guidance for around 25% growth in operating earnings in the first half has been reiterated, although Goldman Sachs suspects some extra work will be required in the second half to achieve this rate.

The guidance is not as strong as Goldman Sachs expected, albeit the 14/16 Penfolds release is expected to provide significant earnings growth in the first half. Still, there could be a risk to achieving guidance, given a more conservative view on Chinese growth, although the broker acknowledges this is likely priced into the stock at current levels. Moreover, there are reservations stemming from the subdued result from US competitor, Constellation Brands.

Morgans reinstates coverage with an Add rating and $17.20 target and believes the company is on track to deliver on its growth plans. The broker asserts the stock, post last year's sell-off, is attractively priced for its growth profile.

While there are over 70 brands in the portfolio, the focus is on a small group of priority brands, where the company has pricing power. Treasury Wine has also been reducing the lower-margin commercial volumes in order to focus on luxury and masstige, given its strongest performance is in these categories, and margins are also higher.

Luxury wine now comprises around 76% of the non-current inventory and around 56% of total inventory. The company is also less exposed to the wine cycle as it moves to a brand-led organisation.

China/Asia

Morgans believes there is plenty of growth to be achieved in the Asian business, where the company has achieved a compound growth rate of 44%. Treasury Wine is highly leveraged to the rising demand in China for luxury imported wine. Morgans observes plenty of opportunity to expand representation with existing and new customers in China.

Ord Minnett is also confident in Asian growth, notably China, because of the Penfolds brand and the route to market. Penfolds has boosted sales with support from wholesaler bundling, a common strategy by fast-moving consumer goods companies.

The broker expects demand to remain strong in China, despite weak export data from Australia being signalled for September and October. This is blamed on tough comparable numbers, as Treasury Wine stocked its warehouse in the previous period.

Citi believes the data indicate a more mixed outlook for China, although concedes issues in China are more driven by sentiment than fact, as there is little sign of weakness. Pricing is also up 16% in the three months to November 2018.

US Outlook

Goldman Sachs points to the Constellation Brands result which highlighted weakening trends in US wine sales. The broker does not believe Treasury Wine will be unaffected in this regard and reduces estimates for top-line growth in the Americas to 13.9% from 16.1%, based on weakness witnessed in the Nielsen scan data and Consolation Brands commentary.

Goldman Sachs, not one of the eight stockbrokers monitored daily on the FNArena database, maintains a Neutral rating and $13.40 target. Macquarie is less concerned about the implications of the Constellation Brands result, given non-premium wines appear to be struggling the most and depletions appear weaker than for Treasury Wine.

The broker believes the suggestion by Constellation Brands that the focus is on higher retail price points is a positive read for Treasury Wine. A combination of a recent sell-off in the stock and increased conviction of the likelihood of margin improvement in the US, as well as a strong supply of luxury wine, underpin Macquarie's Outperform rating.

Morgan Stanley agrees the premium positioning of Treasury Wine versus Constellation Brands will limit its exposure to the soft commercial trends. The broker expects the company will expand its margins in 2019 as distribution changes are incorporated.

Citi sticks by a Sell rating, noting that, while Constellation Brands is losing market share in the US, demand trends in the industry have also slowed. The broker finds it hard to placate investor concerns, estimating one third of the growth in first half EBITS can be attributed to favourable currency rates and the vast majority of the remainder to a better 2016 vintage. The broker would need to witness consistent volume and pricing growth to become more positive.

The change in route to market in the US and ongoing premiumisation should still underpin Treasury Wine, Ord Minnett asserts. The company is going direct in California, Florida and Washington and these three states are collectively 25% of revenue. Changes are also being made to distributors in other states, which comprise 15% of revenue. Ord Minnett calculates the shift provides access to an incremental 6.25% in EBITS margin.

The new distribution strategy in the US and cost reductions, as well as the lower Australian dollar, underpin the business while acquisitions offer further upside to Morgans' forecasts. Margin should increase over time as third-party distributors are removed from some regions (see above).

Once the company has completed its new route to market strategy Morgans believes it will be in a position to make further acquisitions. There has been speculation that Treasury Wine is interested in acquiring Chateau Ste Michelle Wine Estates in Washington, owned by Altria.

On the other side of the ledger, numerous private equity groups have also expressed interest in Treasury Wine over the years and Morgans notes a strong Chinese interest in the Australian wine industry.

FNArena's database has four Buy ratings, one Hold (Deutsche Bank) and one Sell (Citi). The consensus target is $17.07, signalling 15.7% upside to the last share price. Targets range from $14.50 (Citi) to $20.00 (Ord Minnett).

Retailing Difficulties Reach Into 2019

Discretionary retailing encountered difficult Christmas trading in 2018 and brokers suspect a depressed consumer environment bodes poorly for the upcoming reporting season.

-December retail trading in Australia deteriorated relative to preceding months -Margin issues loom large for specialty apparel & accessory retailers -Food inflation continues to support supermarket growth

By Eva Brocklehurst

The Christmas shopping season of 2018 heralded more angst than usual for retailing, given the number of headwinds prevailing for consumers both domestically and globally. A reasonably solid November appears to have given way to a poor outcome in December, particularly for specialty retailers.

Ord Minnett points out investors are negatively disposed to discretionary retail, as good news appears to be ignored and bad news punished, and this theme may continue until countered by the delivery of strong results.

Morgan Stanley lowers its estimates for discretionary retail stocks under coverage to reflect the soft environment and weak Christmas trading. Headwinds include falling house prices, "Black Friday" discounting and weaker equity markets.

Meanwhile, Amazon continues to expand its offering and extend its advertising, although the impact appears limited to date. Morgan Stanley also notes consumers appear to be browsing online then transacting in-store yet, while this increases conversion rates, a soft market still prevails. New vehicle sales fell -14.9% in December, calculated to be the largest fall since the global financial crisis.

Most of Deutsche Bank's survey contacts signalled trading at the end of 2018 was much weaker than previously expected, and some said it was the worst Christmas for a number of years. Traffic and sales were soft and margin issues loomed large for specialty apparel & accessory retailers.

The broker notes consumers have been trained to buy on promotions and Black Friday in November pulled sales out of December. Department stores appear to have performed better than specialty retail, a departure from recent trends.

Retail sales increased in November a little more than expected but less than the increase recorded in the prior November and, Morgan Stanley calculates, annual growth fell to 2.8% for the year from 3.6%. Strength occurred in apparel, while furniture and restaurant sales disappointed the broker. Electronics sales, while strong and helped by Black Friday sales, were less than the prior November.

In other categories, furniture/furnishings slowed versus trend while hardware was relatively resilient. Online takeaway food growth was 9.7% in November while total takeaway sales grew 1.7%.

The data are even weaker when taking into account inadequate seasonal adjustments, Credit Suisse asserts. The broker notes online transactions contributed 40% of the growth in retail sales in November. While discretionary retail is likely bearing the brunt of slower consumer expenditure, the broker suggests supermarkets may be "a place to hide".

Stock Outlook

Citi notes performances over Christmas were very stock specific, with the strongest feedback coming from Woolworths ((WOW)), Coles ((COL)) and Accent Group ((AX1)), which appear to have the most upside to market expectations along with Super Retail ((SUL)) and Premier Investments ((PMV)).

Following several years of discounting, ramping up to unsustainable levels in some categories, the broker notes this has stabilised and retailers in most categories have not resorted to increased discounting.

Credit Suisse envisages upside for Caltex ((CTX)) as it develops a convenience strategy, which is one of the few trend growth areas in retail. Meanwhile, weakness in the near term could be forthcoming for Wesfarmers ((WES)) in home improvement and Kmart. Still, there is the attraction of further development of the company's industrial businesses.

Ord Minnett comments about the company's Bunnings division, which has indicated slower like-for-like sales growth because of tough comparables and erratic weather, the issue will be the degree to which historical resilience can be maintained. The broker believes the Wesfarmers discount department stores and Myer ((MYR)) face the risk of consumers deferring purchases because of the external environment and this could moderate any trading-down benefits.

Deutsche Bank observes JB Hi-Fi ((JBH)) was among the best of the retailers but finds little scope for the business to outperform while Harvey Norman ((HVN)) is susceptible to weak housing conditions. Deutsche Bank still maintains a Buy rating for the latter, given the property segment and diversification.

Morgan Stanley lowers earnings forecasts for Super Retail, JB Hi-Fi and Harvey Norman to reflect the softer Christmas. An Overweight rating is maintained for JB Hi-Fi, given its earnings are relatively defensive and the competitive intensity in white goods is expected to ease in 2019. Meanwhile, Harvey Norman's earnings are the most tied to the Australian housing cycle and this is expected to create increasing pressure on the business.

Morgan Stanley maintains an Underweight rating for the stock and expects recent improvements in the international operations will fade as global macro conditions deteriorate. Credit Suisse is of a similar view, noting the company's Boxing Day sale commenced several days ahead of Christmas, which is consistent with weakness in December.

A slowing sector is unlikely to support JB Hi-Fi's brand performance, Credit Suisse believes, and the stock appears close to fair value. Ord Minnett points out both Harvey Norman and The Good Guys (JB Hi-Fi) are cycling weak comparables in the second half, which could provide some share price support.

Super Retail could be considered oversold, Credit Suisse acknowledges, although there are unknown issues as a new CEO is still to be announced. On the positive side, the automotive segment is fundamentally solid and underwrites half the value of the stock. Credit Suisse believes the near term risks for Myer are particularly elevated. Citi contends downside risk in FY19 is most apparent for Myer, JB Hi-Fi, Michael Hill ((MHJ)) and Lovisa ((LOV))

Supermarkets

Food inflation continues to support supermarket growth, which was 4.5% in November. Morgan Stanley suggests price rises for food are partly driven by higher input costs linked to the drought but also less promotional activity by supermarkets. Small food retailers grew 4.7% in the month while chain grocery stores grew 3.9% Competitive intensity remains low and has progressively reduced over the past two years, Morgan Stanley points out.

The broker highlights both major supermarkets ran collectables promotions over the Christmas trading period but neither appeared to have huge success, and the first quarter gains by the Coles' Little Shop promotion appears to be an aberration.

Based on channel checks, Woolworths has out-traded Coles for the third straight Christmas period, Morgan Stanley calculates. Costa Group ((CGC)), a supplier of fresh food to supermarkets, has issued an earnings warning but Morgan Stanley finds limited implications for the big three supermarkets.

Valuation largely drives the broker's views on supermarket stocks, with an Overweight rating for Metcash ((MTS)), an Equal-weight rating for Coles and Underweight rating for Woolworths.

Credit Suisse prefers Woolworths to Coles, as the latter's underperformance in fuel is a risk for its first half result, while pressure on cash flow may come from increased capital expenditure in the medium term.

Pricing Sours For Costa, Yet Sell Off Looks Overdone

A sharp drop off in demand for some of its produce over December and into January caused Costa Group to flag a flat net profit outcome for 2018. Brokers believe the market reaction was overdone.

-Weak demand for tomatoes, berries and avocados key to downgrade -Good volume growth opportunities seen in the medium term -Although some recovery in pricing will be required to meet guidance -Scale and diversity likely to support a smoothing of pricing/volatility over the year

By Eva Brocklehurst

The outlook for Costa Group ((CGC)) has been soured by the company anticipating flat net profit in 2018.This substantial downgrade to previous forecasts has driven brokers to review their assumptions. Underpinning the downgrade were softer Australian demand and produce pricing in December and January.

Citrus was weaker because of an early end to the season as well as the lower quality, given it is a biennial crop, and there was a delay in the expansion of the mushroom business (Monarto) in South Australia. The company has reiterated 2019 guidance, which implies net profit of over $78m.

Yet the update has highlighted the risk of oversupply, in Ord Minnett's view. The broker believes the company has good volume growth opportunities for the medium term, but some recovery in pricing will be required, as well as a strong profit gain in the six months to June 2019, in order to meet full year guidance.

The former lofty share price, Credit Suisse acknowledges, did imply hope for long-term high-output pricing, as well as significant margins. Still, tough domestic conditions have provided a reason to reconsider assumptions. Credit Suisse believes 2019 net profit growth should remain strong and above guidance of 30% growth versus 2018.

The key news in the announcement was the fact domestic berry pricing was soft in late December and early January. However, Credit Suisse notes the big swing in 2019 profit versus 2018 is likely to be driven by citrus and the international business, not the domestic berry market. Domestic berry operations are a fairly mature business, the broker points out.

Macquarie agrees the company remains well placed, with a solid market position, but its high PE (price/earnings) status meant a severe negative reaction in the share price, and multiples de-rating by over -20%.

Management signalled that 80% of the downgrade to profit estimates was based on subdued demand for tomatoes, berries and avocados in December. Ord Minnett suspects a re-rating is unlikely until the market is convinced the issues are temporary.

Demand Clarity

UBS suspects questions will be asked about the cause of the declines in price and, although the company has stated the issues are not structural, an oversupply in a number of core categories has always been a risk.

The main concern for UBS is the subsequent impact on prices for avocados, tomatoes and berries. The broker is concerned about whether consumers may be trading down, or whether the company's categories are becoming mature.

Also, is Costa Group losing market share? The company believes market share has been maintained. Even so, while retaining a Buy rating, UBS has become less convinced about the outlook. The broker acknowledges a good job in mitigating supply side risks but the risk on the demand side was previously underestimated. The broker suspects the issues regarding declines in prices will persist beyond 2019.

International

In its defence, the company has a leading market position and strong intellectual property, while the international business underpins a double-digit growth outlook. UBS expects international business will comprise around 41% of group earnings (EBITDA) by 2025 and, if the expansion in China proves successful and further plantings are announced, this could move to over 45%.

Management has emphasised second half 2018 losses in Africa, as it consolidates operations, and Credit Suisse suspects the 12-month margins may not be fully understood as yet.

Meanwhile, China is a start-up operation and 2019 revenue is expected to double off a low base. Hectares bearing fruit are expected to double in 2019. Credit Suisse significantly lowers medium-term margin assumptions, acknowledging its estimates were too high for the international business.

Goldman Sachs believes drivers of earnings growth are unchanged and 2019 is likely to be a strong year as capacity in Morocco and in China is ramped up. The broker, not one of the eight monitored daily on the FNArena database, envisages 31% upside potential to its new target of $5.90 and upgrades to Buy from Neutral.

Credit Suisse agrees investors have become overly nervous, as the announcement does not have material consequences for 2019, and the net profit impact for 2018 is immaterial to valuation. The broker upgrades to Outperform from Neutral as a result.

Macquarie points out that the company's scale and diversity tends to smooth out pricing/volatility over the course of the year. The broker notes the earnings profile has become skewed to the January-June half year, which is more pronounced in 2018 because of the additional farming cost investment that was required over July-December, and thereafter as a result of expansions in both Morocco and the avocado business.

This has been further complicated by the decision last August to change the company's financial year end to the calendar year. Macquarie points out, in practice, this means Costa Group on a calendar basis will bank a large percentage of its profits in its new first half to June, and, thus, there will be more visibility on the outcomes for the full year at the mid year. This compares with the former position where a large second half skew meant profits swung late in the year, which reduced visibility.

Costa Group has a $5.67 consensus target on the database, signalling 13.2% upside to the last share price. This compares with $7.47 ahead of the downgrade. There are three Buy ratings and one Hold (Ord Minnett).

Magellan Financial, Simply The Best?

Wealth manager Magellan Financial's fund flows stood out in the December quarter and a better outlook has prompted several brokers to review their ratings.

-Strong first half expected and fund performance likely to enhance flows -Fund flows are, nevertheless, emanating from a narrow business mix -Flows likely to build at a slower rate than in the past

By Eva Brocklehurst

Magellan Financial ((MFG)) performed strongly over the December quarter, while many of its peers did not. This realisation has inspired several brokers to place the fund manager at the top of their pecking order.

A better outlook for fund flows has prompted Morgan Stanley to upgrade to Equal-weight, equal best in its view alongside Pendal Group ((PDL)). Global equities, in particular, have been strong for Magellan Financial.

Active ETF (exchange traded funds) flows have recovered, which suggests there is renewed retail demand. Moreover, brokers believe the business should benefit from the launch of the Airlie Australian equities to retail clients.

However, Morgan Stanley resists moving to Overweight because the flows are coming from a narrow business mix and there is no product with emerging market exposure. The company's advertised retail fees for global equities remain above peers, which signals a risk that prices will be reduced down the track, similar to what Platinum Asset Management ((PTM)) endured in 2017.

Morgan Stanley also points out that the core global equity strategies are nearing capacity with institutional clients, reducing the potential for large institutional mandate flows. Yet, institutional inflows show further capacity for existing clients, with St James Place expected to bring in $500m to $1.0bn per annum in future years, Credit Suisse asserts.

Outlook

Credit Suisse believes there is an opportunity for a PE re-rating and retains an Outperform rating. The broker considers the concerns voiced over longer-term growth prospects are overplayed. While flows will build at a slower rate than in the past, opportunities still exist for Magellan.

Australian asset managers are trading near 15-year lows and, while a gradual recovery is expected, Morgan Stanley believes outflows will continue, and a substantial re-rating of the sector is unlikely in the near term.

While the outlook remains uncertain in 2019, Ord Minnett prefers those managers that carry strong alpha (performance relative to benchmarks) and momentum into the new year. Magellan's FUM is 22% higher at the end of the first half versus the prior corresponding half, which underpins around 20% profit growth in FY19.

Ord Minnett envisages more upside for Magellan versus Platinum Asset Management. Over the six months to December 2018 only Magellan produced a positive return (1.5%) and around 6.2% alpha versus the MSCI World index in Australian dollars.

Morgans upgrades to Add from Hold, although acknowledges heightened global market volatility poses a short-term risk. A strong first half is expected while the performance of its funds will enhance the stability of flows.

The longer-term options on the balance sheet include acquisitions and new product development. The main risks are a severe market downturn and sustained underperformance that leads to material outflows.

Morgans expects the first half result will provide few surprises, given FUM and performance fees are known and guidance on expenses has been provided. Any update on the demand for sustainable strategies or further utilisation of the balance sheet could be a catalyst, in the broker's opinion.

Two brokers on FNArena's database are yet to update on the latest quarterly from Magellan Financial. There are five Buy ratings and one Hold (Morgan Stanley). The consensus target is $29.24, signalling 6.6% upside to the last share price. The dividend yield on FY19 and FY20 forecasts is 5.8% and 5.9% respectively.

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

Perpetual Under Pressure

Negative markets and outflows caused Perpetual to report a decline in funds under management in the December quarter and brokers expect the share price will remain under pressure in the near term.

-Equity market falls are expected to put pressure on the fund manager's margins in the first half -Challenges for the incoming CEO in executing a turnaround -Global equity business also showing little sign of traction

By Eva Brocklehurst

Fund manager Perpetual Ltd ((PPT)) is performing below historical levels, while the outlook for flows in the near term appears to brokers to be skewed to the downside. New management is also yet to provide detail on the long-term strategy.

The company reported funds under management (FUM) of $27.7bn in the December quarter, down -8% because of negative markets and outflows. Outflows were primarily driven by equities product. Perpetual has experienced -$3bn in outflows over the past year yet, while the disappointments continued in the second quarter, brokers assess there was an improvement from recent years.

The improvement quarter on quarter was mainly a function of reduced outflows from institutions and the first capital raising from the LIC channel in over four years also helped, Citi points out. Still, the Industrial Share Fund and the Australian Share Fund continue to underperform benchmarks by -200-400 basis points over one, three and, five years.

The fall in equity markets has meant a larger decline in higher-margin product that is expected to put pressure on the margins in the first half. The company has suggested, in the past, that low interest rates and a value-based philosophy underpin relative investment underperformance and, despite recent volatility, this still seems to Citi to be a feature.

Credit Suisse downgrades estimates for earnings per share by -3-4% over FY19-21. The broker believes the stock carries some value appeal, as it is trading at a -22% discount to the ASX 200 and bears a 7.5% net dividend yield.

Nevertheless, a weaker fund performance and a sell down in equity markets makes Credit Suisse pessimistic about a turnaround in flows any time soon. This could also make it challenging for the incoming CEO to execute a turnaround driven by organic growth.

Citi reduces estimates following the recent fall in equity markets. The valuation appears undemanding, but the combination of a less-than-optimal investment performance, depressed fund flows and lack of assurances over the strategic direction signals to the broker a Neutral rating is required.

Ord Minnett also expects the share price to remain under pressure, despite the supportive dividend yield, at least until markets recover and/or the new management team strategy can be assessed. The broker expects an interim underlying net profit in the first half of $62.7m, down -12.4%, mainly because of lower average FUM in the Perpetual Investments division.

First half investment losses

Morgan Stanley notes seed investments of around $75m could lead to - $5m in investment losses pre-tax, or around -5% of first half earnings. The broker also suspects there could be investment losses on the Exact Market Cash Fund.

In view of a fall in equity markets Citi estimates an unrealised loss of around -$7m for the first half but factors in gains in future periods, as new accounting standards will now require unrealised gains and losses on the financial assets to be taken in the income statement and this is likely to mean greater volatility in results going forward.

However, Morgan Stanley suspects the market is likely to look through this. FUM was -2% below forecasts, and this represents downside risk to the broker's earnings estimates for FY19 and FY20 by a similar amount.

Citi is also unsure whether the first half loss would be discounted in determining the interim dividend, although additions to retained profits should provide scope if the board chooses to do so. The global equity business also shows little sign of traction, and Citi would not be surprised if the new CEO ultimately considers acquisitions to fix the issue.

FNArena's database has four Hold ratings for Perpetual. The consensus target is $34.75, suggesting 6.7% upside to the last share price. The dividend yield on FY19 and FY20 consensus forecasts is 7.4% and 7.5% respectively.

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: Bulks, Gold & Base Metals

A glance through the latest expert views and predictions about commodities. Commodities sector outlook; China policy; gold; nickel and copper.

-High bulk commodity prices likely to ease back in line with end-market steel -China's looser fiscal policy likely to lead to modest support for commodities -Robust backdrop for Australian gold sector, although valuations becoming stretched -Uncertainty likely to persist for nickel until US/China trade conflict ebbs

By Eva Brocklehurst

Outlook

On the back of new commodities prices forecasts, and downgrades to iron ore, oil and base metals, Goldman Sachs moves Fortescue Metal ((FMG)) to Sell. The broker maintains Buy ratings for BHP ((BHP)), Rio Tinto ((RIO)) and Alumina Ltd ((AWC)), believing the upcoming February reporting season will be a catalyst for Australian bulk miners, supported by record shareholder returns and further disciplined investment in growth projects.

The broker's economists forecast growth in China will bottom in March/April, and heightened uncertainty regarding the timing and magnitude of policy responses is likely to result in downside to both bulk and base metals over the first quarter of the year. Goldman Sachs cuts 2019 forecasts for aluminium by -4%, copper by -6%, zinc by -21%, nickel by -34% and oil by -11%.

Iron ore forecasts are reduced by -5% for 2020. The broker expects iron ore to drop to US$60/t in the second quarter of 2019 because of increased seaborne supply and weaker Chinese steel demand. Despite the downgrades, the broker believes a broad-based recovery in base metal prices is likely in the second half, amid a broader economic recovery.

Deutsche Bank observes high bulk commodity prices have been propping up the resources sector but expects prices will catch up with end-market steel. Iron ore is forecast to move down to US$62/t and temporary dips below this level are not ruled out.

The broker eases back on its view for copper, now forecasting the red metal will be range bound for more than two years. A slowdown in China's property sector is expected to start affecting iron ore, which has so far been resilient. Steel consumption in China is forecast to decline to only 1% growth in 2019, from 7% in 2018.

Ord Minnett maintains a neutral stance on the ASX resources sector. The broker continues to believe Rio Tinto presents the more compelling value opportunity on a number of metrics, but along with BHP will be affected by any weakness in Chinese macro data. The broker continues to like Fortescue Metals but, as the stock has rallied almost 30% since its September low and is approaching the stockbroker's valuation, downgrades to Hold from Accumulate.

Deutsche Bank believes the BHP share price is yet to reflect the second half 2018 downturn in oil prices, given the enticing shareholder returns on offer. Deutsche Bank downgrades BHP to Sell from Hold.

China Policy

China's central bank will lower the required reserve ratio by 100 basis points for banks later this month. This reduction, together with earlier cuts, is expected to release around RMB800m in new net liquidity. UBS notes earlier liquidity easing cycles have resulted in flat-to-rising commodity prices and mining equities.

A similar scenario is possible in 2019, which is consistent with the broker's overweight call, albeit this time around the positive effect is likely to be modest because of the lower commodity intensity and infrastructure & fiscal stimulus.

The broker also points out this time around China's property sector is in better shape versus the 2014-16 cycle of fiscal easing. Excess capacity and related financial risks are also lower now, although the cycle is similar in that the government wants to support growth. Hence, commodity demand is likely to be supported through 2019.

Gold

Ord Minnett believes the robust macro economic backdrop for the gold sector can accommodate further moves in the gold price. ASX gold stocks have substantial operating margins and provide an excellent portfolio hedge into reporting season, the broker suggests.

However, macro uncertainty is likely to prevent marginal buyers from returning in the next six months. Mid cap stocks have outperformed the large caps recently and the broker notes Evolution Mining ((EVN)) and Northern Star Resources ((NST)) have been the preferred stocks for global investors.

Newcrest ((NCM)) has greater leverage to a rising gold price, given its production base and mine life, while OceanaGold ((OGC)) also appears good value, with the longest mine life of the broker's mid cap coverage. Ord Minnett awaits an update on Pogo before becoming more positive on Northern Star and downgrades St Barbara ((SBM)) to Hold from Accumulate on valuation.

Deutsche Bank, on the other hand, suspects the safety premium in gold is starting to stretch valuations. The broker continues to favour those stocks with non-US dollar costs and organic production growth. Newcrest and Evolution Mining are downgraded to Hold and Sell, respectively, on valuation.

Nickel and Copper

A ceasefire in the US/China trade war has meant nickel prices have stabilised, after falling around -32% over the second half of 2018. UBS notes the news flow has mostly been positive surrounding the negotiations, and further stimulus from China in the way of infrastructure projects has kept those shorting the metal in check.

Still, uncertainty is likely to persist until the US and China settle their differences. The broker points out the latest data show both Chinese and global stainless steel output were solid in the second half of 2018 and inventories are falling. Demand indicators may have deteriorated but this has not yet shown up in fundamentals.

Meanwhile, new Indonesian intermediate supply threatens the market although UBS assesses Chinese efforts to bolster sentiment should stabilise demand. Any further de-escalation in the conflict between the US and China should mean nickel outperforms other commodities over 2019.

Deutsche Bank reduces its price outlook for copper and nickel, leading to an average -10% fall in valuation for the sector. The down shift is not distributed evenly over stocks. In copper, the broker's valuation for Oz Minerals ((OZL)) is down -5% while the valuation for Sandfire Resources ((SFR)) is down -15%. On an historical average basis, the broker acknowledges both stocks show value.

In nickel, Deutsche Bank's valuation for Independence Group ((IGO)) has fallen -7% while the valuation of Western Areas ((WSA)) has fallen -18%. Likewise, on an historical average basis, both stocks show value.

Material Matters: Outlook, Iron Ore & Copper

A glance through the latest expert views and predictions about commodities. Resources outlook; iron ore; and copper.

-CLSA prefers resource equities with exposure to commodities supported by Chinese policy -Pull back in grade differentials has helped Australian iron producers -China's scrap import restrictions likely to support refined copper demand in 2019

By Eva Brocklehurst

Resources Outlook

CLSA expects a rebound from the pessimism experienced in the resources sector in December. The broker is cautious, given the macro uncertainty, despite strong profitability across stocks. Quality is preferred: equities with value and strong balance sheets as well as exposure to commodities supported by Chinese policies, such as rare earths, aluminium and iron ore.

The broker has made three changes to recommendations after incorporating its first quarter commodity price deck, upgrading Alumina Ltd ((AWC)) to Buy from Outperform and downgrading Rio Tinto ((RIO)) and Fortescue Metals ((FMG)) to Outperform from Buy.

Base metal price forecasts are lowered by an average of -10% for 2019 to reflect the macro headwinds, weaker sentiment and lower spot prices. This is countered by modest near-term upgrades for bulk commodities.

CLSA flags the defensive characteristics of gold and aluminium and continues to like copper for the medium term. The broker believes market concerns about growth, both globally and in China, are overstated, although acknowledges markets are forward-looking. Global growth in 2020 is expected to be at the slowest pace since 2015.

Iron Ore

Macquarie reviews the iron ore industry's cost curve and notes costs for delivered ore have changed little. The seaborne marginal cost is still set by the low-grade producers in India, Iran and Australia. The broker calculates that, at US$50/t, up to 90% of the market remains cash positive. Macquarie calculates an average break-even price of US$51/t for Fortescue Metals in 2018.

Of note, a pull back in grade price differentials in the December quarter occurred and a correction in China's steel industry margins has benefited Australian producers at the end of 2018.

Macquarie also expects Fortescue to move lower on the cost curve in 2019/20 as its product mix improves, with the proportion of higher grade fines rising to almost 25% once Eliwana reaches full production. The stock is trading at a significant discount to Macquarie's spot price valuation with significant upside potential at current commodity prices and exchange rates.

Shipping rates for Australian iron ore miners have also improved in December, the broker points out. December quarter is historically strong for Australian exports and buoyant iron ore prices continue to drive momentum in the major iron ore producing stocks. Prices now centre on US$73/t.

Credit Suisse expects prices may hold up at around US$70-$75/t during the current quarter, as China's steel output has been surprisingly strong and port stocks are depleted. Once steel mills cease re-stocking the price is expected to slide and the broker maintains a forecast for US$61/t in the second quarter of 2019.

Port traders appear to have aggressively bid for spot cargoes to replenish holdings. However, Credit Suisse notes not all grades have been resilient, as 65% iron grades remains at the lower end of its 2018 price range and China's 65% blast furnace's pellet premium has halved since October. In contrast, 58% grades are near 2018 peaks.

Macquarie assesses Rio Tinto is on track to hit 2018 production guidance. Meanwhile, the train derailment has had a greater impact on BHP's ((BHP)) iron ore shipments than previously expected. Macquarie cuts BHP's December quarter shipment forecasts by -13% and does not expect a recovery in FY19, forecasting shipments to come at the lower end of the guidance range.

Copper

The copper price has recovered from recent lows, and Macquarie observes it moving back towards US$6000/t. The broker highlights a tendency for copper to trade sideways for a period before a sudden move to a new level.

As long as the US/China trade conflict does not worsen, Macquarier suspects the next move should be upwards at some point. Demand conditions appear less optimistic than they were 12 months ago, as Chinese growth has slowed and vehicle & white goods sales data have shown consumer spending activity declined.

However, grid investment has returned to an upward trend in recent months. Macquarie maintains a view that a shift towards rising late-stage construction activity will benefit non-ferrous metals. The risky area of demand for copper, in the broker's opinion, is consumer products.

Supply is expected to slip slightly in 2019, with refined output growing at 2.0% as opposed to the 2.8% in 2018. As a result, Macquarie believes there will be a slight deficit in 2019 which could mean the market would remain flat, even if Chinese demand turns out to be somewhat lower or there are fewer disruptions to supply.

Morgan Stanley points out China's copper scrap imports fell by a third in 2018 and this helped lift demand growth for refined metal. The shortfall emanated from regulations that were introduced throughout the year.

The government has stated it intends to ban all solid waste imports from 2020 and copper will be most affected. Although disruptive, the broker estimates the net loss of imported copper units in 2018 was just -60,000t, since falling scrap imports were partly offset by processing elsewhere.

Over time, China is expected to expand offshore processing and raise its domestic recovery rates. The current low price for copper is expected to continue to hinder scrap collection and distribution globally.

Import restrictions can also be expected to drive increased investment in China in scrap collection and processing. All up, Morgan Stanley believes the extension of the import ban will support refined copper demand in 2019 and offset some slowdown in end-use demand.

Goldcorp-Newmont Deal Points To More M&A

By 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.

Goldcorp-Newmont deal points to more M&A

More gold mines will be going on the block thanks to a blockbuster gold mining company tie-up announced Monday. And major gold companies will also be looking to acquire large, preferably high-grade deposits, due to the ever-present problem of depleting mine reserves, as extraction costs become more expensive and profit margins squeezed without a significant rise in the gold price.

These are the two main takeaways from the merger of Goldcorp and Newmont Mining which creates the largest gold company in the world - knocking “New Barrick” (the merged Barrick Gold and Randgold) off the top of the pedestal.

The consolidation started with the takeover of Africa-focused Randgold by Barrick in September; the all-share deal was worth $6.5 billion. After years of languishing gold and gold mining stock prices following gold’s record price of $1,900 an ounce in 2011, some of the biggest gold miners are finally ready to raise the white flag - overwhelmed by eroded profit margins amid (relatively) low gold prices compared to the 2011 top, and higher costs of production.

The gold price was down 5% in 2018 due mostly to the appreciation of the US dollar throughout last year and steady demand for US Treasury bills. More importantly though, gold is getting harder to find.

Mine production falling

The mined supply of the precious metal is shrinking as most of the “low-hanging fruit” has been mined and the rest is either in remote locations or buried deep in the earth, meaning higher extraction costs.

2016 was the first year that mine production fell since 2008. In spring 2018 the World Gold Council in its annual gold trends report said that total gold supply slipped in 2017 to 4,398 tonnes – a drop of 4% from 2016. Mine production was about the same as last year, 3,268.7 tonnes, but recycled gold fell 10% to 1,160 tonnes. Key gold producers that saw drops in 2017 were China and Tanzania.

Global gold-mine discoveries reached their peak in the early 1980s according to data from specialists MinEx Consulting.

In the first half of 2018 output the top three gold miners - Barrick, Newmont and Goldcorp - fell 15% compared to H1 2017, at the same time as the oil price climbed, meaning cash flow fell off a cliff.

Falling production has been a trend for some time, that will eventually signal a move up in price.

South African gold production has plummeted below 250 tonnes compared to 1,000 tonnes in the 1970s, and China, the leading gold producer, is the only country to increase production in recent years, notes Goldcore via ZeroHedge.

Lower grades, higher costs

Why is production falling? For the most part it’s due to lower grades. In 1998 Barrick was producing gold, mostly from its Nevada operations, at 9.6 grams per tonne. As Barrick added more mines its production rose, peaking in 2006 at 8.6 million ounces, but its average yield was 1.71 g/t. The company’s production and grades have both fallen since then, producing 5.3 million ounces in 2017 at 1.68 g/t.

The lower grades have meant production costs have risen significantly. As shown in the slide below, in 1998 Barrick needed 55 loaded trucks a day to move 2.3 million ounces at its Goldstrike and Cortez mines. In 2017 it had to load 220 trucks per day to produce the same amount of gold. That’s a four-fold increase in the amount of ore needed to be transported, resulting in much higher fuel, labor and processing costs.

MINING.com reported that gold mining costs are up 22% since the gold price bottomed out in the first quarter of 2016.

Victims

Between the first half of 2017 and the first half of 2018, production from the top three gold miners Barrick, Newmont and Goldcorp – fell 15%.

Analyzing the financial performance of the top three, SRSrocco Report concluded that "The biggest loser was Barrick, whose production declined over 20% by falling to 2.1 million oz in 1H 2018 compared to 2.7 Moz in the previous year. Goldcorp's production fell 10%, while Newmont's output dropped by nearly 9%".

In the first half of 2018 free cash flow at the combined top three plummeted from $718 million in the first half of 2017 to just $38 million in H1 2017.

Seeking Alpha went further in an October 2018 analysis. Combining data from the three largest gold companies, Simple Digressions found that revenue in the first three quarters of 2018 dropped by 9.4% versus Q1, 2 and 3 of 2017. Comparing the same periods, the amount of gold the top three sold fell 11.3%. A higher unit cost of production ($674 per ounce in the first 9 months of 2018 versus $610/oz in Q1, 2 and 3 of 2017) meant a $3.3 billion gross margin for the first three quarters of 2018 versus $4.1 billion in the first 9 months of 2017.

Goldcorp is clearly the best example of a gold miner in distress. In a timely article published the weekend before the $10-billion Goldcorp-Newmont deal, the Globe and Mail noted that Goldcorp's shares on Friday traded for $12.86 apiece versus $54 in 2011 - a 17-year low.

CEO David Garofalo has been heavily criticized over the insipid stock price, but the trouble started before he took over in 2016. Goldcorp made some really dumb moves at the top of the mining supercycle, and has a string of missed targets. In 2006 it paid US$430 million for the Eleonore project in Quebec. The mine was supposed to produce 600,000 ounces of year but in 2018 only managed 350,000 oz. The Cocheneur development property in Ontario was initially touted as a 5 million ounce deposit, but has since been downgraded to 300,000 ounces in reserves. Another recent disappointment was the Coffee property Goldcorp bought from Kaminak Gold for $530 million. Infill drilling recently cut the reserves by 23%, to 1.7 million ounces.

"In general the world's production is on the verge of a sharp decline due to the development of previously proven reserves and the lack of new discoveries." Andrey Lobazov, mining analyst at Aton

In 2017 Goldcorp paid over half a billion dollars for a 50% stake in the Cerro Casale mine in Chile, but nothing has happened, with the project considered too low grade, too remote, and too expensive to develop, the Globe and Mail reported. Same with another project Goldcorp bought in Chile, Caspiche - the company has yet to convert its 12.5 million ounces into reserves.

Despite all of these mis-steps, Goldcorp was Canada's second largest gold producer and the third largest in the world by market value, before Monday's takeover.

Targets?

Given the poor performance of the top three gold miners, who could be the next M&A targets? Bloomberg names AngloGold Ashanti, Newcrest and Kinross Gold as possibilities. The publication also won't rule out New Barrick (doesn't that sound weird?) for further deal-making, quoting its new CEO, Randgold's Mark Bristow, saying they are not "going to be sitting on our hands should there be other opportunities."

Bloomberg also states that with two huge deals in the gold sector recently signed, "the pressure on those left behind will be even greater":

The two mega deals promise to transform the industry that many investors have shunned due to floundering bullion prices and poor decision making by producers. The newly combined companies are also expected to put several unloved assets up for sale, leaving lots of room for maneuvering by those that missed out on the dealmaking so far. Newmont has said it would sell a billion to $1.5 billion in assets over the next two years.

Big deposits scarce The bear market of 2012 to 2016 meant most large gold companies slashed exploration budgets and small explorers had an extremely tough time raising cash. The industry is seeing a significant slowdown in the number of large deposits being discovered. Frank Holmes quotes Franco-Nevada co-founder Pierre Lassonde saying recently that he doesn't know how we'll replace the massive deposits found over the last 130 years:

"If you look back to the 70s, 80s and 90s, in every one of those decades, the industry found at least one 50+ million ounce gold deposit, at least ten 30+ million ounce deposits and countless 5 to 10 million ounce deposits. But if you look at the last 15 years, we found no 50 million ounce deposit, no 30 million ounce deposit and only very few 15 million ounce deposits," states Lassonde.

"The future pipeline is [now] almost devoid of 'world class' projects. Gold production [must either] be sourced from a greater number of smaller operations, or face a sharp contraction in capacity," Mark Fellows, Metals Focus' head of mine-supply analysis

Discoveries have indeed tapered off. According to S&P Global Market Intelligence, between 1999 and 2017 there were 222 discoveries, compared to just 41 in the 10 years before 2017. In 2017 no discoveries were made. As high-grade reserves are depleted (refer to the Barrick example above), and costs rise, gold miners are being forced to be more efficient and to acquire new deposits to replace their reserves. This of course is good news for our junior miners, whose job in the mining food chain is to keep the supply of minerals moving, through discoveries that are usually bought, either through project purchases or company acquisitions, by larger mining companies. Simple economics also dictates that as supply diminishes, the price will go up. Considering the rarity of gold - it is present in much smaller quantities than other metals - the fact that production is decreasing, and that new discoveries are few and far between, we are setting up for a continued rise in the gold price, irrespective of investment and jewelry demand. Last week we reported that the price is ticking up so far this year, helped by a lower US dollar and higher demand from ETF holders and central banks. Ross Norman, CEO of Sharps Pixley, notes this week that the gold price is currently within a few percentage points of being at an all-time high in 72 currencies, not including the US dollar.

The recent M&A is great news for the gold industry and the gold juniors. I'm looking forward to seeing who comes forward with the next major deal.

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

Oil Outlook Remains Under Tension In 2019

Compliance with the OPEC-led agreement is expected to underpin oil prices in the first half of 2019, while the remainder of the year may be subject to more volatility.

-Oil market debate centres on whether a supply gap will emerge -Downside risks include elevated Chinese imports and high percentage of oil in transit -Focus is on progress with growth projects for Oz energy stocks

By Eva Brocklehurst

Analysts are generally of the view that the first half will contain the highs in the oil price for the year and there will be a deterioration later in 2019, but uncertainty is heightened as policies are driven by geopolitics.

Commonwealth Bank analysts lower the oil price outlook for the next 18 months and now expect Brent to peak at US$72/bbl mid year. Ongoing compliance with the OPEC- led deal is expected to be the primary driver of higher oil prices through the first half. The analysts downgraded the oil price outlook in November, subsequent to a US decision to grant waivers to countries importing crude oil from Iran. This meant more was available to the market.

The downward revision to estimates was also underpinned by constraints on US oil infrastructure. However, Canada's oil sector has revealed that producers only lower output as a last resort and US shale oil producers are expected to behave in a similar fashion.

The analysts expect oil prices will ease later in the year as US infrastructure constraints are reduced. Expiry of the OPEC-led supply agreement will also add downward pressure. The three main producers, the US, Russia and Saudi Arabia, each have their own targets for the oil price, setting the scene for ongoing tension.

Citi suspects OPEC assurances about stabilising markets may actually be creating more volatility. OPEC et al have moved from a rapid surge in supply mid 2018 to calls for another production cut, after Brent fell to US$50/bbl at the end of December from US$86/bbl in early October.

The debate is seen centring on whether a supply gap is emerging. Saudi Arabia and the IEA (International Energy Agency) envisage a supply gap will emerge in the next few years, although Citi doubts this will be insurmountable at prices of US$45-60/bbl for West Texas Intermediate (WTI). The key meetings for OPEC energy ministers are in Vienna over March and April.

Morgan Stanley believes the market is likely to be broadly balanced in 2019, which supports a partial recovery in the oil price. Still, the broker expects this will be capped at US$65/bbl, while the sharp fall in Brent has arguably overshot a deterioration in fundamentals.

Oil Price Trajectory

After reviewing the potential trajectories for oil inventory, Citi revises forecasts slightly higher, expecting Brent to average US$62/bbl in 2019, mainly because of the potential for a tight moment at the end of the year from new lows in observed inventory. Stock is expected to then build in 2020, even if OPEC et al maintain production cuts to the end of 2020.

Morgan Stanley, on the other hand, believes the market is likely to be broadly balanced in 2019, which supports a partial recovery in the oil price. Still, Morgan Stanley analysts expect this will be capped at US$65/bbl. As said, the sharp fall in Brent is seen as an overshoot to a deterioration in fundamentals.

As OPEC reduces output, non-OPEC output is unlikely to slow down. Balancing the market would require OPEC's discipline to continue well into 2020. OPEC's market share is falling and, Morgan Stanley points out, oil prices rarely rise strongly when this happens.

Downside risks for the market in the short term, the broker suggests, include elevated Chinese imports and a high percentage of oil in transit and floating storage. Morgan Stanley points out this is reminiscent of late 2016 when several countries increased production sharply in October of that year and it took several months for this increase to make its way through the system.

While OPEC cut production in early 2017 the draw down in inventory failed to materialise for several months. In 2019, this is likely to keep the oil market well supplied, at least in the first half. Further out the broker suspects supply cuts and a boost in demand should restore the balance and support a partial price recovery, but only to the mid US$60/bbl region for Brent.

Australian Energy Stocks

Morgan Stanley considers US$65/bbl an attractive price for the Australian oil producing sector, as significant work has been done on cost structures and balance sheets over the last two years

The broker retains Overweight positions on Santos ((STO)), Beach Energy ((BPT)), and Woodside Petroleum ((WPL)). Progress on LNG developments, including PNG LNG, Scarborough, Browse and Darwin LNG are themes to watch in 2019. Meanwhile, the broker believes stability in oil prices will be good for service companies and that the recent pull back in WorleyParsons ((WOR)) shares is overdone.

Further reserve upgrades are expected in the Cooper Basin and there is potential for incremental capital management. Morgan Stanley also queries whether Woodside may lift its dividend above the 80% pay-out ratio, and whether Beach Energy can start to pay a more meaningful dividend.

Citi advises investors should look at the latter's net debt position to determine how fast the business is de-gearing and whether there is any FY20 hedging in the upcoming results.

Progress on growth projects will be the focus for UBS in 2019. Woodside has made significant progress with all three of its key growth projects and catalysts include a FID (final investment decision) in Senegal and Scarborough and Browse entering FEED (Front End Engineering Design).

The focus for Oil Search ((OSH)) will be FEED for PNG expansion and the business in Alaska. Brownfield asset growth is expected for Santos as well as FID for Barossa. Origin Energy ((ORG)) is expected to focus on APLNG and sales volumes from energy markets. Citi will be on the look-out for the sale of Ironbark.

Citi believes investors should check for whether a fully termed Browse-NWS tolling agreement has been signed when Woodside reports in February, as well as results of flow testing in Myanmar.

Updates on the construction of gas processing for Senex Energy ((SXY)) will also be sought. East Coast gas production continues to decline, Citi observes, and supply from LNG exporters is likely to remain muted for a time as the focus turns to the international markets and the uptick in demand in the northern hemisphere.

The broker notes LNG project contribution to the domestic market during peak winter showed this were functioning well, with pricing relatively flat and indicating no shortfall in supply. The broker believes Australian gas prices of $8-9/GJ are here to stay, which is positive for both Beach Energy and Senex Energy.

Lastly, sector analysts at Credit Suisse upgraded their recommendation for Beach Energy to Outperform from Neutral this morning on the expectation of further consolidation in east coast gas supply with Beach expected to play a leading role in the process. Two potential targets put forward by Credit Suisse are Cooper Energy ((COE)) and Bass Oil ((BAS)).

Could There be a Copper Wipeout?

By Marin Katusa

On Wednesday, January 2 , CEO Tim Cook halted Apple stock and stated that the company's earnings would fall well short of analysts' expectations. A key reason behind the revenue miss was slowing Chinese demand.

Tim Cook made the shortfall about the "trade wall" but he forgot to mention that iPhones aren't even a top 5 phone in China. Maybe Apple's overpriced products aren't what the mainland Chinese want?

Anyways, to a bigger theme, slowing Chinese demand...

Slowing Chinese demand is becoming a key theme for equity and commodity markets alike. And while a few less iPhone sales won't affect the copper market, global consumer spending habits and economic health certainly will.

Make no mistake, I am very bullish on the long-term prospects for copper. I believe the world will become more electrified, which means increased copper demand. However, in the short run, macroeconomic signals are telling me that we could see one more wipeout.

Below I'll tell you what the data and my analysis are saying.

51.4 billion pounds of copper was consumed globally in 2018. This represents a 1.08% increase over the same period in 2017. The chart below shows annual copper consumption since 1995.

The average annual copper consumption growth rate since 1995 has been 3.16%. However, over the last few years growth rates have slowed significantly. The average growth rate from 2015 to 2018 is around 0.83%.

The consensus long-term estimates by most analysts is that copper will see a 2.5% annual increase in demand. At this rate, global shortage of copper would occur in the mid-2020s. And that can only be resolved by higher copper prices to bring on higher-cost production. But, 1% copper growth doesn't cause higher copper prices.

In fact, the copper price would decrease as supply would exceed demand over the next few years.

Charts to Watch #1 – Copper Forward Curves

I have been paying very close attention to the forward curve (which is what forward hedges are based on). The futures curve are prices expected by buyers and sellers in the months and years ahead. And it has been decreasing a lot over the past six months.

You'll see that the expected prices today are much lower than six months ago.

Here's an example...

On July 3 2018, copper prices were expected to be around US$3.00 per pound in January 2020. Today, copper destined for sale in January 2020 is expected to sell for less than US$2.60 per pound.

Below is a chart which shows monthly copper demand. The blue line shows global demand excluding China. It's clear that copper consumption is actually slowing down. The question is, will China still consume the red metal as it has in the past? Or will China's consumption also cool down?

Charts to Watch #2 – Global Copper Inventories

Inventories have declined in recent months, but are nowhere near alarming levels.

Below is a chart which shows copper inventories at both places like the Shanghai and London Metal Exchanges (on exchange), as well as private warehouses (off exchange). The sum of "on" and "off" exchanges equals the global inventory level for copper.

Charts to Watch #3 – Copper Days of Supply

Let's take this a step further and divide total global inventory levels by global demand. This ratio generates a number I like to call "Days of Supply."

A high number indicates there is no shortage of supply and is bearish for copper prices. A low number indicates there could be a supply crunch on the horizon and would be bullish for copper prices.

Right now, the copper market is sitting at around 10 days of supply, based on known inventories and consumption levels. Given that days of supply has dropped from 20 to 10 in the matter of months, we can infer that demand is outpacing supply.

The billion-dollar question is, how are inventory levels going to stop falling? Is supply going to increase, and match consumption levels? Or will consumption levels fall? I believe that in the short term, it will be the latter.

I think we are going to see weak copper consumption out of China and the emerging markets, which accounts for over 50% of global consumption. If I'm right, copper prices are going to remain under pressure for the short term.

Top Copper Stocks and Their Performance in 2018

Below is the sector performance of copper companies as an index. You can see that being exposed to copper producers has been a tough place to be.

I have been intimately involved in the copper sector for almost 15 years. I've been on the board of one of Canada's largest copper producers for 13 years now. I have firsthand experience taking an exploration project to production.

It's been an incredible learning lesson. And one that I've taken to help improve my investment and speculation moving forward. I want to increase my exposure to copper, but timing is key.

I have updated the performance of all the copper producers year-to-date. The universe of copper producers that make up the indexes above are in the chart below. You can see all of the publicly listed copper producers and their year-to-date share price performance.

An interesting "mining fact" to think about: This time ten years ago, the copper universe would have had 80 companies listed. Today there are 29 companies.

Even though some of the world's top copper producers have fallen over 20% year-to-date, some will fall a lot more before they have their day in the sun again. The above price carnage all happened as the price of copper fell from US$3.30/lb to the current US$2.64/lb.

Let's be totally clear, there is a global economic slowdown happening. There are many reasons for this, but the stronger U.S. dollar relative to other fiat currencies is a big concern for the emerging market.

A strong U.S. dollar makes commodities (and the debt associated with those projects) more expensive for the emerging markets (especially when the emerging market nation's currency is depreciating). And increasing interest rates means borrowing those U.S. dollars will be even more expensive for companies in the emerging markets. This results in less demand for commodities from the emerging markets and China.

This slowdown will cause copper consumption rates to fall from its 30-year average of 3% to 0-1% growth. Or even negative growth in copper demand within the next 36 months. Copper production above US$2 per pound is quite stable over the next 24 months. Yes, I know all the copper bulls will troll me online because of this statement. Do as you please.

There will be no shortage of copper in the next couple of years, regardless of if copper is US$2.50 a pound or US$2 per pound. As prices decline, copper producers and developers will see their share prices fall significantly. This is what will cause what I am calling the copper wipeout.

And then the cycle will begin again, because the cure for low prices... is low prices.

Again, I have set myself up with a high percentage of cash (in U.S. dollars) for when the coming Copper Wipeout occurs. I don't know when it will happen, but I believe it will and will prepare accordingly.

I will only be buying the following two kinds of companies:

1. World-class, lowest cost quartile operating companies with strong balance sheets at massive discounts 2. Drilled out world-class discoveries that will be bought out by larger companies

Those will be the first to rebound post Copper Wipeout.

Then as those stock prices surge, the market will look further down the food chain for the next win. This means the development and exploration companies will see an influx of buying. But that will be after the wipeout begins to recover.

Everything I write in Katusa's Resource Opportunities is what I am doing with my own money in the resource markets. Companies like Freeport (which was once the copper king) will be crippled by their debt in a rising interest rate environment. Add to that Freeport's exposure to AK-47 nations, and the once "Best Copper Miner in the World" will lose its title. Then it'll either merge or sell off its best assets to stay alive.

Commodities are a cyclical business, as are the reigning champion producers. The entire copper production landscape will change after the next wipeout. That said, I have my wish list of copper producers I want to buy.

My eyes are laser focused on a few stocks, but until the wipeout occurs, I'm waiting to pounce. I believe the share prices of even the best producers will go lower. Then there will be an incredible opportunity to make a tidy fortune.

katusaresearch.com

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 January 7 to Friday January 11, 2019 Total Upgrades: 9 Total Downgrades: 8 Net Ratings Breakdown: Buy 46.41%; Hold 40.64%; Sell 12.95%

Welcome to 2019! Stockbrokers have been rather busy while you and I and most of our peers were enjoying too many lazy meals, drinks and extra-burning sunshine.

Let's first focus on last week, ending Friday January 11th.

For the week, FNArena registered nine upgrades and eight downgrades for individual ASX-listed stocks, with Woodside Petroleum (2x upgrades) and Class ltd (2x downgrades), respectively, stealing the show on both sides of the ledger. If there are any themes to pay attention to, they are that companies operating in the fringes of the automobile sector seem to have been cast aside too easily, according to analysts, while energy and miners divide, and bricks & mortar retailers simply cannot find any new friends.

Apparently, Christmas sales have been awful, and reasonable at best for the better performers in the sector. Gold miners are losing favour now that equities in general are trying to build a base.

In terms of target prices, everything was relatively quiet during the week. Vocus Group is the only one worth mentioning on the positive side. On the negative side we find heavy reductions taking place for the likes of Class and Kathmandu (analysts have not been quick in responding to Costa Group's profit warning).

As far as earnings estimates are concerned, the balance is decidedly in favour of falling forecasts, which are needed for the current healing process to run its course. QBE Insurance, Santos and Woodside Petroleum have been enjoying positive adjustments, while notable reductions have arrived for companies including Sydney Airport, Syrah Resources, Challenger, Japara Healthcare, Suncorp and Costa Group.

For the period stretching back to Monday December 17, 2018 (last time FNArena updated for the calendar year gone), FNArena registered six upgrades for ASX-listed individual stocks against four downgrades. Unfortunately technical limitations have prevented us from including tables and overviews for the full period.

Have been upgraded since December 17: Atlas Arteria, Bega Cheese, GWA Group, nib Holdings, Paradigm Biopharmaceutical and Sigma Healthcare. Have received downgrades since: APA Group, Inghams Group, Panoramic Resources and Villa World.

In terms of positive amendments to valuations and price targets, Sigma Healthcare enjoyed a nice boost, whereas adjustments for GWA Group, APA Group and Origin Energy were negative.

Ironically, GWA Group stands out as one major beneficiary in terms of positive momentum for earnings estimates (thanks to an acquisition across the Tasman), while consensus forecasts for Western Areas, Independence Group, Mineral Resources, Sonic Healthcare, Senex Energy, Fortescue Metals, Perseus Mining and Pinnacle Investment Management are all notably turning lower.

The year is young, but already companies such as Costa Group and Kathmandu had to warn investors about disappointing operational dynamics. On the other hand, Treasury Wine came out strongly and decisively, issuing positive guidance for the present year, despite some of its peers suffering, as did Noni B.

The gap between these two groups will be one of the defining characteristics of the February reporting season. To be continued.

Upgrade

ARB CORPORATION LIMITED ((ARB)) Upgrade to Hold from Lighten by Ord Minnett .B/H/S: 2/2/0

Ord Minnett analysts observe the shares have meaningfully de-rated since June-August last year, significantly underperforming the S&P/ASX Small Industrials. They only see minor near-term risk to earnings.

Following the above changes, the analysts believe the risk-reward looks balanced for investors who'd like a piece of what remains a "high-quality business led by seasoned management, with a business model that has continued to see sales growth despite economic cycles".

Recommendation has been upgraded to Hold from Lighten, while the target price has been pulled back to $15.70 from $17.

DOMINO'S PIZZA ENTERPRISES LIMITED ((DMP)) Upgrade to Neutral from Sell by Citi .B/H/S: 2/2/3

Citi has upgraded to Neutral from Sell post significant de-rating of the share price since November last year. The analysts declare they don't see any near-term upside earnings risks, but they retain the view this company has "significant" earnings growth prospects in Europe.

On Citi's projections, average EPS growth will be 16% over the next three years. On this basis, the target price is set at $43.40 (down from $45.20).

In terms of the upcoming reporting season, Citi believes top line is likely to be trending near the low end of the range, with Domino's chances for beating its own guidance not seen as high. The suggestion made is that when the share price were to fall below $39, Citi will be ready to upgrade to Buy (all else remaining equal).

GALAXY RESOURCES LIMITED ((GXY)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 4/1/0

Macquarie has taken a positive view following the announcement made by Pilbara Minerals ((PLS)), indicating strong demand from potential customers for hard rock lithium miners.

Pilbara Minerals remains the broker's top pick in the sector, with ongoing cautious view for Altura Mining. Galaxy Resources' rating is hereby upgraded to Outperform from Neutral.

Concerning the latter, Macquarie has pushed back the development assumption for Sal de Vida by circa 6 months with first production now expected in late-2022. Target price declines to $2.70 from $3.

MAGELLAN FINANCIAL GROUP LIMITED ((MFG)) Upgrade to Add from Hold by Morgans .B/H/S: 5/0/1

Morgans notes the strong performance by the Magellan funds, including the Infrastructure Fund. This, say the analysts, should bode well for funds flows in the months ahead.

Short term risk stems from volatile equity markets, but Morgans has nevertheless decided it's time to upgrade to Add from Hold. Target price lifts to $28.76 from $28.54.

MONASH IVF GROUP LIMITED ((MVF)) Upgrade to Add from Hold by Morgans .B/H/S: 2/0/0

Share price action suggests the IVF sector is poised for more disruption, argue analysts at Morgans. They note company management stuck to guidance at the AGM in November, albeit with a stronger H2 to compensate for a weak H1.

The stockbroker has taken the view that investors are probably too negative (as judged by share price weakness) and thus the rating is upgraded to Add from Hold. Price target falls to $1.13 from $1.21 on reduced "underlying" forecasts.

NETWEALTH GROUP LIMITED ((NWL)) Upgrade to Neutral from Underperform by Credit Suisse .B/H/S: 0/4/1

Marking to market, Credit Suisse analysts have reduced estimates for asset managers and operators of financial platforms. More so for the former (-6% on average versus -1% on average).

The analysts highlight while share prices have de-rated noticeably, many asset managers are also experiencing fund outflows, and this can potentially still accelerate on continued risk off sentiment.

As net flows have improved on the back of new partnerships, post the present year earnings estimates have slightly increased. Upgrade to Neutral from Underperform. Target price remains $7.75.

SANTOS LIMITED ((STO)) Upgrade to Hold from Reduce by Morgans .B/H/S: 3/3/0

Recent share price weakness has pushed Santos shares into "fair value" territory, on Morgans' assessment, hence why the rating has been upgraded to Hold from Reduce.

The broker has put through higher oil price forecasts in its model, while noting balance sheet pressure has been alleviated on the combination of significant cost-out initiatives and a recovery in the oil price.

Target price has fallen to $5.53 from $5.59. Upside risk remains with the PNG operations, suggest the analysts.

WOODSIDE PETROLEUM LIMITED ((WPL)) Upgrade to Neutral from Underperform by Macquarie and Upgrade to Add from Hold by Morgans .B/H/S: 5/2/0

Macquarie sees oil prices strengthening in the first half of calendar 2019. On this basis, the rating for Woodside Petroleum has been lifted to Neutral from Underperform.

Sector preference remains (in order) Oil Search ((OSH)), then Santos ((STO)), with Woodside last among large caps "due to certainty and timing around catalysts for the first two".

Macquarie believes Woodside is facing a challenging year ahead, though it is seen as a candidate to announce a buyback or special dividend. Target price falls to $33.30 from $34.70.

Stockbroker Morgans has upgraded to Buy from Hold, observing Woodside Petroleum's ebitdax margin of 72% is nothing but "exceptional". The quality of earnings is supported by what the analysts deem are "low risk" operations.

Morgans has had difficulties to look beyond the company's lack of growth, but the analysts see fundamentals for LNG and crude oil operations improving, and this is likely to support the sanctioning of Browse, Scarborough and Kitimat LNG, suggest the analysts.

The updated modeling has also incorporated higher oil price forecasts. Estimates went up. The target price lifts to $37.83 (was $36.74). Noteworthy: DPS forecasts have been reduced.

Downgrade

AUTOSPORTS GROUP LIMITED ((ASG)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 1/1/0

Ahead of the interim results report release next month, Macquarie is expecting to see ebida contracting by -11% from a year ago, predominantly because of weak market conditions.

The bad news is: the analysts see these conditions somewhat being entrenched. On this basis, the recommendation has been pulled back to Neutral from Outperform.

Estimates have been reduced by double digit percentages, with pronounced effect on DPS forecasts. Target price drops to $1 from $2.30. Stock is illiquid, which doesn't help, plus Macquarie sees risk as to the downside, still.

BHP GROUP ((BHP)) Downgrade to Sell from Hold by Deutsche Bank .B/H/S: 5/2/1

A general sector update on mining stocks has triggered a downgrade for BHP to Sell from Hold at Deutsche Bank. The price target has fallen to $29.60 from $36 with the analysts pointing out margins have peaked for the Big Australian and earnings forecasts are now rolling over; a first in three years.

Underlying the broker's thesis is a tipping point for the Chinese property sector into the negative. This leads to the expectation of commodity markets likely to move into a trough in Q1, hitting prices for iron ore and crude oil, among others.

On revised forecasts steel consumption in China is projected to decline from 7% growth in 2018 to only 1% in 2019. The key property sector is expected to experience a decline from 10% growth to nil growth. Short term forecasts for most base metals have been scaled back.

CLASS LIMITED ((CL1)) Downgrade to Hold from Buy by Ord Minnett and Downgrade to Hold from Add by Morgans .B/H/S: 1/2/0

Ord Minnett focuses on the rapidly slowing pace of growth for the company, with the analysts starting to question how large precisely the ultimately addressable client base turns out to be.

The broker has made further material cuts to forecasts. Target price tumbles to $1.30 from $2.43. Recommendation is downgraded to Hold from Buy.

Morgans has further lowered expectations for Class with the analysts suggesting the overall market dynamics are not easy for the company, as SMSF formation is likely slowing down, in particular if Labor wins the upcoming federal election.

In the short term, the broker believes the overall landscape remains highly competitive. Rating downgraded to Hold from Add. Target price falls to $1.48 from $2.65.

Current projections imply the company will defend its annual dividends for shareholders at 5c per annum.

EVOLUTION MINING LIMITED ((EVN)) Downgrade to Sell from Hold by Deutsche Bank .B/H/S: 2/4/2

A general sector update on mining stocks has seemingly led to a downgrade for Evolution Mining to Sell from Hold at Deutsche Bank.

The price target for the gold miner improved to $3.30.

HIGHLANDS PACIFIC LIMITED ((HIG)) Downgrade to Hold from Add by Morgans .B/H/S: 0/1/0

Morgans advises shareholders to take no action with Cobalt 27 Corp having agreed to acquire all outstanding shares at 10.5c per unit.

The analysts point out, part of the process will be a shareholders' meeting to approve the scheme of arrangement, which will require the approval of 75% of non-conflicted shareholders.

Downgrade to Hold from Add. Target price falls to 11c from 33c

KATHMANDU HOLDINGS LIMITED ((KMD)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 1/3/0

The company's trading update didn't exactly excite, and that is putting it mildly, missing management's own expectations. Macquarie downgrades to Neutral from Outperform.

The analysts suggest macro uncertainty, NZ weather and retail competition in general are all impacting. Forecasts have been lowered. Target price slumps to $2.28 from $3.13.

NEWCREST MINING LIMITED ((NCM)) Downgrade to Hold from Buy by Deutsche Bank .B/H/S: 2/5/1

A general sector update on mining stocks has seemingly led to a downgrade for Newcrest Mining to Hold from Sell at Deutsche Bank.

Target price improved to $24 from $23.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 ARB CORPORATION LIMITED Neutral Sell Ord Minnett 2 DOMINO'S PIZZA ENTERPRISES LIMITED Neutral Sell Citi 3 GALAXY RESOURCES LIMITED Buy Neutral Macquarie 4 MAGELLAN FINANCIAL GROUP LIMITED Buy Neutral Morgans 5 MONASH IVF GROUP LIMITED Buy Neutral Morgans 6 NETWEALTH GROUP LIMITED Neutral Sell Credit Suisse 7 SANTOS LIMITED Neutral Sell Morgans 8 WOODSIDE PETROLEUM LIMITED Buy Neutral Morgans 9 WOODSIDE PETROLEUM LIMITED Neutral Sell Macquarie Downgrade 10 AUTOSPORTS GROUP LIMITED Neutral Buy Macquarie 11 BHP GROUP Sell Neutral Deutsche Bank 12 CLASS LIMITED Neutral Buy Morgans 13 CLASS LIMITED Neutral Buy Ord Minnett 14 EVOLUTION MINING LIMITED Sell Neutral Deutsche Bank 15 HIGHLANDS PACIFIC LIMITED Neutral Buy Morgans 16 KATHMANDU HOLDINGS LIMITED Neutral Buy Macquarie 17 NEWCREST MINING LIMITED Neutral Buy Deutsche Bank Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 VCX VICINITY CENTRES 63.0% 30.0% 33.0% 4 2 NWL NETWEALTH GROUP LIMITED -20.0% -50.0% 30.0% 5 3 WPL WOODSIDE PETROLEUM LIMITED 64.0% 36.0% 28.0% 7 4 GXY GALAXY RESOURCES LIMITED 80.0% 60.0% 20.0% 5 5 SGP STOCKLAND 25.0% 7.0% 18.0% 6 6 MGR MIRVAC GROUP 25.0% 7.0% 18.0% 6 7 MFG MAGELLAN FINANCIAL GROUP LIMITED 67.0% 50.0% 17.0% 6 8 STO SANTOS LIMITED 50.0% 33.0% 17.0% 6 9 DMP DOMINO'S PIZZA ENTERPRISES LIMITED -19.0% -31.0% 12.0% 8 10 ARB ARB CORPORATION LIMITED 50.0% 38.0% 12.0% 4 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 CL1 CLASS LIMITED 33.0% 100.0% -67.0% 3 2 NSR NATIONAL STORAGE REIT -17.0% 13.0% -30.0% 3 3 KMD KATHMANDU HOLDINGS LIMITED 25.0% 50.0% -25.0% 4 4 VOC VOCUS GROUP LIMITED -33.0% -17.0% -16.0% 6 5 DXS DEXUS PROPERTY GROUP 20.0% 33.0% -13.0% 5 6 NCM NEWCREST MINING LIMITED 6.0% 19.0% -13.0% 8 7 BHP BHP GROUP 50.0% 63.0% -13.0% 8 8 LLC LENDLEASE GROUP 30.0% 42.0% -12.0% 5 9 GMG GOODMAN GROUP 30.0% 42.0% -12.0% 5 10 SCG SCENTRE GROUP 25.0% 36.0% -11.0% 6 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 VOC VOCUS GROUP LIMITED 3.027 2.960 2.26% 6 2 NCM NEWCREST MINING LIMITED 21.464 21.339 0.59% 8 3 VCX VICINITY CENTRES 2.913 2.900 0.45% 4 4 SCG SCENTRE GROUP 4.338 4.333 0.12% 6 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous

Target Change Recs 1 CL1 CLASS LIMITED 1.727 2.493 -30.73% 3 2 KMD KATHMANDU HOLDINGS LIMITED 2.777 3.060 -9.25% 4 3 NSR NATIONAL STORAGE REIT 1.597 1.660 -3.80% 3 4 LLC LENDLEASE GROUP 15.438 15.857 -2.64% 5 5 BHP BHP GROUP 35.966 36.880 -2.48% 8 6 GXY GALAXY RESOURCES LIMITED 3.370 3.430 -1.75% 5 7 ARB ARB CORPORATION LIMITED 18.795 19.120 -1.70% 4 8 DXS DEXUS PROPERTY GROUP 10.498 10.665 -1.57% 5 9 GMG GOODMAN GROUP 10.342 10.452 -1.05% 5 10 CHC CHARTER HALL GROUP 7.288 7.350 -0.84% 4 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 QBE QBE INSURANCE GROUP LIMITED 78.170 75.425 3.64% 8 2 STO SANTOS LIMITED 38.224 36.913 3.55% 6 3 WPL WOODSIDE PETROLEUM LIMITED 206.405 199.626 3.40% 7 4 MFG MAGELLAN FINANCIAL GROUP LIMITED 174.583 172.990 0.92% 6 5 GWA GWA GROUP LIMITED 22.853 22.725 0.56% 5 6 FMG FORTESCUE METALS GROUP LTD 43.493 43.267 0.52% 8 7 GXY GALAXY RESOURCES LIMITED 5.437 5.409 0.52% 5 8 AQG ALACER GOLD CORP 3.317 3.300 0.52% 4 9 RIO RIO TINTO LIMITED 703.860 700.755 0.44% 7 10 NCM NEWCREST MINING LIMITED 87.322 86.938 0.44% 8 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 SYD SYDNEY AIRPORT HOLDINGS LIMITED 17.766 20.323 -12.58% 8 2 SYR SYRAH RESOURCES LIMITED -6.617 -6.077 -8.89% 5 3 CGF CHALLENGER LIMITED 58.886 63.886 -7.83% 8 4 JHC JAPARA HEALTHCARE LIMITED 7.050 7.600 -7.24% 4 5 SUN SUNCORP GROUP LIMITED 78.517 84.183 -6.73% 8 6 CGC COSTA GROUP HOLDINGS LIMITED 25.734 27.154 -5.23% 5 7 CL1 CLASS LIMITED 6.433 6.767 -4.94% 3 8 SDA SPEEDCAST INTERNATIONAL LIMITED 28.132 29.520 -4.70% 4 9 PTM PLATINUM ASSET MANAGEMENT LIMITED 28.800 30.050 -4.16% 4 10 IAG INSURANCE AUSTRALIA GROUP LIMITED 42.429 44.171 -3.94% 8 Technical limitations

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

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.

The Wrap: Building, Media, Consumers & EVs

Weekly Broker Wrap: Oz infrastructure; building materials; media; consumer; property; and electric vehicles.

-Is the outlook softening for Oz infrastructure sector? -US housing exposure the bright spot for Oz building stocks -Negative advertising expenditure could prove painful for media equity values -Challenging backdrop for traditional retailers continues in 2019 -Despite sales strength, caution advised as China contemplates cuts to EV subsidy

By Eva Brocklehurst

Australian Infrastructure

Recently, Australia's infrastructure sector has benefited from certainty regarding earnings and distribution yields as well as incurring double-digit growth rates. However, Citi believes the outlook is softening as tax expenses are rising and there is pressure on debt costs. The broker has downgraded Sydney Airport ((SYD)) to Sell from Buy, suggesting headwinds are gathering pace.

Regulatory uncertainty and high leverage are also factors driving underperformance. The broker is also cautious about Transurban ((TCL)), maintaining a Sell rating, as there is potential for increased volume sensitivity to economic conditions. Leverage, expenditure and the credit cycle also place downward pressure on the pay-out ratio.

Building Materials

Morgan Stanley believes 2019 in the building industry will be all about balancing diverging exposures. The broker avoids Australian housing and favours infrastructure and US housing exposure.

The Australian infrastructure construction environment remains the most attractive end market, in the broker's view, and growth will continue in US housing, albeit at a more modest rate. Hence, Overweight ratings are maintained for both Boral ((BLD)) and James Hardie ((JHX)).

For the former, developments with the USG JV may also bring upside if a favourable deal can be achieved. For the latter, Morgan Stanley believes the current share price reflects an overly bearish view regarding the trajectory of US housing and a return to primary demand growth.

Morgan Stanley upgrades Adelaide Brighton ((ABC)) to Equal-weight. While believing it will be difficult for the stock to outperform until a new strategy is announced, the broker concedes the stock offers attractive leverage to the Australian infrastructure boom and is now trading at a more realistic multiple.

Fletcher Building ((FBU)) has streamlined its organisation and repaired the balance sheet but Morgan Stanley believes the NZ housing market is at a peak and declines are inevitable. Therefore, more attractive exposures exist elsewhere. Meanwhile, the broker suspects the share price of CSR ((CSR)) is likely to over-correct as 2019 shapes up as a challenging year. This should provide an opportunity for patient investors.

Credit Suisse forecasts 3.0% growth in US housing starts in 2019 and, while the rate is moderating, still expects growth to continue through 2020. Affordability is the main concern, although mortgage rates have declined from the November highs. Renovations demand is likely to be underpinned by a home owner base locked into legacy low mortgage rates amid expectations house prices will continue to appreciate.

The broker notes exposure to new residential construction is less than 5% for Reliance Worldwide ((RWC)), which is its top pick in the sector as a result. James Hardie, with around 40%, still has a majority of its exposure to renovations as well as momentum in market share. Credit Suisse decreases forecasts for Boral, Neutral rated, based on the US outlook and indications weak conditions are carrying into the second quarter for both the US and Australia.

Media

While Morgan Stanley expects advertising expenditure to be softer, a recession is not in base case estimates. After three consecutive months of negative data in 2018 and discussions with industry, the broker reduces estimates across media companies.

Morgan Stanley believes investors should be aware of how painful negative advertising expenditure could prove to be for equity values. The broker has Underweight ratings on traditional media stocks, which reflects both negative structural change and cyclical revenue/earnings risk. The only Overweight rating in traditional media is the new Nine Entertainment ((NEC)) amid cost reductions and potential for a lift in asset values.

Consumer Stocks

Australian Bureau of Statistics data for November shows retail sales rose 2.8%, below October because of slowing discretionary sales growth. This was driven by electronics and the result of cycling the iPhone release in the prior corresponding period. The main drags on non-food included furniture, electrical and hardware. UBS considers this negative for Super Retail ((SUL)), Harvey Norman ((HVN)) and Wesfarmers ((WES)).

Department stores and clothing/footwear were positive and the broker suspects November was aided by Black Friday/Cyber Monday sales which pulled forward items from the key December period. Softer foot traffic data makes the broker cautious about discretionary expenditure in December and January.

Macquarie agrees the backdrop is challenging for traditional retailers, which are dealing with a combination of structural and cyclical pressures, particularly the apparel sector. Within the consumer segment the broker prefers Wesfarmers and Coles ((COL)) in staples and JB Hi-Fi ((JBH)) in discretionary retail.

The broker has conducted a survey of unlisted retailers to ascertain holiday trade and the outlook. Almost half of all respondents indicated trading was negative over Christmas for their business, and apparel was particularly weak. The bright spot were electronics, which reported stable conditions. Macquarie agrees online trade in November from Black Friday/Cyber Monday caused a pulling forward of sales and created a hole in the higher margin pre-Christmas trade.

Supermarkets were the highlight of November retail sales, up 4.5% and well above the 12-month run rate. UBS believes the results benefited from strong online sales which may have pulled forward from December. November marks the sixth consecutive month of above-trend growth in food. Liquor dragged on overall sales, which may have continued into December because of cooler weather whether in that month.

Property

From the survey of unlisted retailers Macquarie notes they are less bullish on floor space needs than they were five years ago. Only around 7% of large retailers intend to increase space on a one-year view compared with around 61% back in 2014. Store network rationalisation is expected to continue, with 24% indicating an intention to decrease space over the next 12 months.

Hence, Macquarie is cautious about leasing conditions for retail landlords. The broker's preferences remain for A-REITs within other sub-sectors, including Goodman Group ((GMG)), Dexus ((DXS)), Mirvac ((MGR)) and Charter Hall ((CHC)), all rated Outperform. The broker has a Neutral rating for Scentre Group ((SCG)) and GPT ((GPT)).

Electric Vehicles

Electric vehicle sales ascended to a new record high in December, bringing the 2018 total to 2m vehicles. Macquarie observes this is positive for battery materials such as cobalt, lithium and nickel but bearish for the platinum group elements, particularly as, overall, car sales shrank.

Annual sales of automobiles were lower in 2018 for the first time since 2009. The significance of this is that the market share of electric vehicles has risen quickly. Moreover, the importance of China to global electric vehicle growth cannot be underestimated. Chinese electric vehicles accounted for 53% of global sales in 2018.

Still, this is why Macquarie is cautious about the 2019 outlook for sales, as China is expected to announce major cuts to subsidies. Speculation exists that these may be larger than previously expected - between 42-55%.

The broker suspects it will be difficult for the rest of the world to take up the slack, even though this year US sales were up 83% on the back of Tesla's successful launch of the Model 3. Europe is expected to do better as the Model 3 arrives there while Japanese and European offerings are also more diverse.

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

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

Rudi's View: Join The CSL Challenge

Included In Today's Story:

-Join The CSL Challenge -Bell Potter's Top Picks For 2019 -Best Wishes From FNArena

Rudi's View: Join The CSL Challenge

By Rudi Filapek-Vandyck, Editor FNArena

For many years I have held a positive view on CSL ((CSL)) shares listed on the Australian Stock Exchange, and I have written and talked about this stock ad infinitum.

And with good reason, one might conclude, as the shares have clocked up more than 400% in returns for shareholders since 2011. Its steady climb in the rankings of local stocks, ranked by market capitalisation, has now made CSL Australia's fourth largest company, only preceded by CommBank, BHP and Westpac.

When I arrived in Australia, eighteen years ago, CSL was but a mid-cap stock. This truly has been, and still is, an incredible success story.

Yet, according to feedback and day-to-day observations, and to my genuine frustration, Australian investors seldom own shares in the company. They remain deterred by other expert voices who tell them you simply cannot buy these shares, they are too "expensive".

Others are wrongfully of the idea that successful investing starts with buying stocks that trade on low Price-Earnings (PE) ratios. So they lose their shirt through owning stocks including Retail Food Group, Vocus, iSentia, AMP, or even IOOF. Then there are those who don't understand the intrinsic weakness that comes with chasing high yielding industrials, which has seen Telstra shares lose more than -50% in just a few quick years.

Plenty of reasons as to why investment portfolios in Australia do not have any exposure to what is undeniably one pivotal success story from corporate Australia over the past three decades, if not ever.

My heart bleeds when questions I receive are whether I think this or that beaten down small-cap industrial stock is finally worth buying, or are Australian banks finally turning the corner? Australian investors, including their advisors and many a market commentator, are way too narrowly focused on finding "value".

Whereas the cold hard truth is CSL shares, carried by exceptional quality and supportive market dynamics, have been one of the best investments any investor could have made since listing in the 1990s. And they most likely still are. This is why Australian investors need to wake up and smell the blood plasma and influenza vaccines, so to speak.

In ten years time, CSL might be this country's most valuable ASX-listed entity, further crowning an already impressive track record. How on earth will Australian investors justify not having been part of its story, instead losing focus, sleep, money, direction and potential return via owning stocks of lesser quality, generating lower returns?

It is my conviction you don't need to. Allow me to provide you with the most valuable investment experience you can possibly expose yourself to in the years ahead.

Add CSL to your portfolio. Maybe include ResMed ((RMD)) and Cochlear ((COH)) as well.

It doesn't matter how many shares you buy. Buy as many as you can be comfortable with. If you are extremely cautious, buy one share of each. It might look like it isn't worth it, given the transaction costs involved, but you can consider those as an investment in your personal education.

And while this is about achieving a return on your investment (of which I am very confident), this is equally as much about education: allow yourself to be surprised by how much benefit your investment portfolio can retrieve from exposure to high quality stocks, with long-term robust growth outlooks.

Once you own a piece of the action, you will feel "connected" to these high quality success stories. You'll pay more attention to what goes around in each particular segment of the global corporate world, you'll read analysts' reports in a different manner, you might even download their annual reports and show up at AGMs.

Most importantly, however, you will learn first hand that, beyond the immediate horizon, "quality" is far more important than cheap "value". The difference may not necessarily reveal itself next week, next month, or even by mid-year. But you can be as confident as I am that your journey will conclude with a positive experience.

So when should you join the "CSL Challenge"?

Pick your moment. My own strategy for buying these High Quality stocks is to wait until the share price weakens. You just have to accept you probably won't be able to jump in at the lowest price point possible, but it's probably not good timing to buy at the summit of a strong short term bounce.

But you will become part of something new, something exciting, and something very beneficial to your own insights and understanding about investing in the share market. I from my end hereby solemnly promise I shall regularly update on share price movement and prospects for all three companies. Once you have joined the CSL Challenge, and you are as yet not on the FNArena mailing list, you can send me an email and I shall keep you posted too (info@fnarena.com).

In case this might have escaped your attention: CSL shares produced a 30% positive return over 2018, despite also falling victim to the bear market sell-off from September onwards. Over the past six weeks, the shares already recovered by circa 10%, significantly outperforming local indices and most stocks listed on the ASX.

CSL shares have now returned to where they were trading in October last year.

But all this short termism is really but noise in the greater scheme of things. We are here to learn what investing and sustainable returns from quality growth stories really looks like, through first-hand involvement.

Who's ready to join the "CSL Challenge"?

I cannot provide any guarantees, but am pretty confident you will not regret this. C'mon, what are you waiting for?

P.S. I couldn't help but noticing CSL shares are weaker today...

P.P.S: Do send me an email once you have joined the CSL Challenge as you will want to remain connected to your High Quality inclusions: info@fnarena.com

Bell Potter's Top Picks For 2019

Stockbroker Bell Potter recently revealed its Favoured Top Picks for calendar year 2019. Keen observers of my own research into All-Weather Performers will notice there are a few names represented in both selections. For All-Weather Performers, including updated share price performances, paying subscribers can access the dedicated section on the website.

Bell Potter's selection of favourites consists of: ALS Ltd ((ALQ)), Caltex Australia ((CTX)), Challenger ((CGF)), CSL, Goodman Group ((GMG)), Macquarie Group ((MQG)), Netwealth Group ((NWL)), Oil Search ((OSH)), Sonic Healthcare ((SHL)), and Woolworths ((WOW)).

Best Wishes From FNArena

FNArena is gradually ramping up its service this month, with broker views and forecasts up to date via The Australian Broker Call, daily emails and news stories resuming this week, and with Greg Peel re-joining us from next Monday onwards.

As I am presenting at the Australian Investors Association's (AIA) one-day seminar in Melbourne on January 29th, Weekly Insights shall resume from the first week in February onwards. Our Australian Corporate Results Monitor is ready to start adding the first results scheduled for the final week of January.

The team here at FNArena wishes you all a prosperous year ahead.

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

P.S. I - 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.