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Stories To Read From FNArena

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Is The Fed Going To Cut?

'It is all over but the shouting' – Brandywine says a -25 basis point reduction in the federal funds rate has become a near certainty on July 31

Financial markets have recently "lobbied" for a return to accommodative monetary policy, although the fundamental supports for an aggressive round of accommodation remain mixed.

J. Patrick Bradley, Senior Vice President, Investment Research at Brandywine Global, a Legg Mason Affiliate, notes: "We have posited the Fed could start easing as early as July, so let's look at several signals below to see to what extent they support Fed dovishness, or even serve as reliable indicators after years of unprecedented policymaking and market conditions."

The Guiding Signs

The recession signals. Today, the Fed's policy rate stands at a range of 2.25-2.50%. The tightening over the course of four years has contributed to an inversion of the yield curve, as measured by the difference between the 10-year Treasury note and the 3-month Treasury bill. This inversion has typically harkened a recession. However, another yield curve indicator of recession—the difference between the 2-year Treasury note and the 10-year yield—remains positive (Chart 1), albeit the curve has flattened dramatically. All told, the two yield curve measures of inversion tell conflicting stories: one measure is flashing recession, the other is not, yet both measures are a cause for market concern. The signal embedded in the yield curve may now be distorted by years of unconventional monetary policy, meaning the yield curve message may be not be the same one as in the past.

The Fed is now less data dependent. Chair Powell's opening statement to Congress contained a rather sanguine view of the U.S. economy, as he reviewed recent growth and the labor market temperature. He did note that a growth slowdown likely occurred in the second quarter and that appears to be confirmed by the Atlanta Fed's GDPNow forecast of just 1.6%.

However, this isn't a great revelation given that neither inventory investment nor trade will replicate the contributions they had to GDP in the first quarter. The U.S. economy recorded surprisingly strong job growth in June. Non-farm payroll employment rose 224,000 in June, surprising analysts. The unemployment rate stands at 3.7%, well below most estimates of the unemployment rate when the economy is at full employment.

Small business optimism, although slipping in June, remains at a historically high level. Small businesses still find it difficult to fill job openings. June retail sales tell the story of a strong consumer and core inflation broke through 2.1%. While the consumption deflator is only rising 1.5%, inflation expectations have rebounded recently, as measured by 2-, 5-, and 10-year break evens.

Rather than domestic data, what is perhaps instead driving the Fed is the increasingly uncertain global economic outlook created by trade tensions and the resulting slowdown in international trade. Would these global forces spillover into the U.S. economy? Being sensitive to that potential outcome may have tempted Chair Powell to depart from his dual mandate of full employment and price stability. Considering monetary policy against this backdrop suggests a move toward risk management, with the Fed using any rate reduction as an insurance policy.

The financial system is stressed and monetary accommodation needs to relieve that stress. Again, the data appears to be inconclusive and depends on how an analyst might measure financial stress. Fortunately, the market has filled the void and a number of measures are available. Some Fed regional banks have constructed indices of financial conditions or financial stress. Private sector analysts have also added to the research. Let's talk about two of them, the Chicago Fed's National Financial Conditions Index (FCI) and The Goldman Sachs Financial Conditions Index (GSI).

The Chicago Fed produces the more comprehensive index that includes over a hundred variables, grouped in three sub-indices that cover risk, credit, and leverage. The series is updated weekly. The other measure is a simpler construct, comprising just five variables, including the trade-weighted dollar, and is available daily. Charts 2 and 3 below show that financial stress is below average.

In both indices, financial stress is measured against average conditions. For the FCI, a reading above zero indicates tightening conditions, while for GSI, 100 is the demarcation between tightening and loosening financial conditions. First, increasing financial stress occurs in recessionary periods and, second, current financial conditions do not reveal financial stress in the system. Lastly, let's include these stress variables in a regression that includes real gross domestic product (GDP) growth as the dependent variable. The two independent variables are both lagged.

Chart 4 compares the actual GDP growth with the fitted value generated by the model. The model suggests growth should be a bit lower, based on current financial conditions, but there isn't sufficient financial stress to generate deteriorating economic growth. Therefore, all we could be looking at is a normal mid-expansion slowdown, in which case, it could provide the Fed with a reason to exercise its "insurance" policy.

Conclusions

Agustin Carstens, General Manager of the Bank for International Settlements, has recognized the potential vulnerabilities created by monetary policy and cautioned central bankers the effectiveness of monetary policy has been reduced and could create vulnerabilities in the financial system.

This observation may have resonance, given Chair Powell's emphasis on uncertainties, which may tilt U.S. monetary policy towards being more prospective. U.S. economic data is not overly supportive of lower interest rates, putting the Fed's focus instead on risk management and taking out an insurance policy against global uncertainties.

The U.S. financial system does not appear particularly stressed and in need of monetary accommodation, but market anticipation of easier policy could have alleviated any system stress. The reduced term premium for U.S. Treasuries can be explained partly by shifting foreign demand, suggesting an inverted yield curve should not warrant extreme caution.

While some of these traditional recessionary signals may have lost some of their potency, their embedded message shouldn't be ignored; perhaps this is the reason why a 25 basis point reduction in the federal funds rate has become a near certainty on July 31, with markets now appearing to price in a total of three rate cuts for 2019.

In spite of this market exuberance, a purely data-driven central bank would be justified in waiting to cut rates. In a few days, we will see whether market expectations were met or misaligned, as they were at the Fed's May meeting.

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Is Time Slipping Away For Woodside?

A sharp downturn in June quarter production and revenue, while perhaps one-off, has caused brokers to question whether Woodside Petroleum's timeline on growth projects is slipping.

-Questions being raised about LNG expansion given weaker market conditions -No formal agreement on the North West Shelf toll with Browse -Uncertainty stemming from timing, tax regimes and carbon policy

By Eva Brocklehurst

Weak production and quarterly revenue that was at its lowest level since early 2010 caused brokers to take a second look at the timeline for Woodside Petroleum's ((WPL)) projects. An extended turnaround at the Pluto LNG facility meant production and sales volumes declined -20% and weak LNG prices also added to a -40% drop in revenue in the June quarter.

Production growth is to be phased over the next few years with key projects in Senegal, expected in 2022, Scarborough, expected in 2023, and Browse, expected in 2026. All are yet to reach a final investment decision (FID). Woodside Petroleum is the operator and should ensure the timetable is followed, but brokers are noting some slippage as certain requirements for proceeding are outside the company's control.

Woodside has not changed full-year guidance, having already indicated that 2019 production would be at the low end of its 88-94 mmboe guidance range. There was no update to the LNG expansion timing but questions are starting to be raised, given weaker conditions and the challenges of aligning the joint-venture partners.

Production at Greater Enfield is drawing closer, although Morgan Stanley assesses this is the biggest risks to forecasts for 2019, as start-up had been assumed from mid 2019. The broker had downgraded the stock early in the year to Equal-weight as risks appeared to be developing regarding the long-term growth plans.

Weak LNG Markets

Since then, weak spot LNG markets, which are well below break-even, limited offtake agreements at Scarborough, with FID looming for 2020, and no formal agreement on the North West Shelf toll, are all starting to bite.

There is also uncertainty in regard to the alignment between BHP Group ((BHP)) and Woodside as to how Scarborough should be developed, either via Pluto train 2 or the North West Shelf. Until some of the factors affecting the outlook are resolved, Morgan Stanley considers it unlikely the stock will outperform peers.

Credit Suisse believes the negatives implied by the June quarter results were largely one-off and over-emphasised by the market. The broker also suggests any upside from Scarborough and the Pluto interconnector are not been valued appropriately.

Credit Suisse was already more conservative regarding costs versus consensus, so was less surprised by higher production costs in the quarter, suspecting this may have been one of the drivers of the negative market reaction. The broker assumes the production cost increases are because of one-off items such as the downtime at Pluto and, therefore, are not recurring, although acknowledges guidance is being sought from the company to clarify this point.

Citi acknowledges turnaround costs at Pluto are the obvious culprit in the June quarter weakness but also suspects North West Shelf contract re-pricing is not being accounted for by the market. The broker also notes the Pluto interconnector has been delayed to 2022 from 2021 because of works downstream, and the dry hole in Bulgaria raises questions about whether higher exploration expenditure is warranted.

The broker believes the market will need to wait for the segment results in August to understand the degree to which the miss to expectations in the June quarter is one-off, but suspects the greater share of the miss is not a result of maintenance costs at Pluto and forecasts may need to reduce into perpetuity.

Citi also notes the Pluto interconnector is been delayed to 2022 from 2021 because of works in the downstream and the dry hole in Bulgaria raises questions about whether higher exploration expenditure is warranted.

Although the company has strongly performing assets, the stock price is trading above Ord Minnett's valuation, based on base case oil price forecasts. The broker is below consensus estimates for 2019 and 2020 on oil prices and maintains a Lighten rating. Based on tax guidance, Ord Minnett estimates net profit for the first half of US$497-630m, well below prior forecasts of US$741m. This has meant a -16% reduction to the 2019 forecast.

UBS also revises 2019 estimates to be -19% below consensus and expects the consensus view will moderate. This puts forecast dividends at risk, given the company's pay-out ratio approach to dividends. Morgans has calculated, if Woodside maintains its ratio at the top end of guidance for a 50-80% pay-out, then on current commodity forecasts this supports the fully-franked yield of around 6%.

Macquarie had factored in the downtime at Pluto, while sales volumes missed estimates because of the timing of condensate shipments. The broker continues to envisage challenges for the company because of uncertainty over tax regimes and carbon policy and downgrades forecasts by -14% for 2019.

The broker has also increased the Wheatstone depreciation schedule which has had a positive impact on the target. Citi agrees the depreciation schedule has caught some off guard, as this is running well ahead of nameplate.

Senegal

The company is also awaiting a ruling on arbitration with FAR Ltd ((FAR)) regarding the Senegal project. Woodside has stated that a resolution on the arbitration is likely to be in the first half of 2020 at the earliest, although guidance is still targeting a final investment decision at the end of this year.

Citi points out project financiers won't lend while arbitration is ongoing, so the final investment decision target appears unrealistic. UBS also points to this disparity in the timeline, despite the company suggesting the two items are mutually exclusive. However, the broker suspects arbitration will only become an issue if the decision goes against Woodside.

FNArena's database has two Buy ratings, three Hold and two Sell. The consensus target is $34.62, signalling 2.4% upside to the last share price. Targets range from $29.13 (Citi) to $38.04 (Morgans, yet to comment on the quarterly). The dividend yield on 2019 and 2020 forecasts is 4.9% and 5.5% respectively.

South32 Asset Sale Holds Key To Outlook

Capital management will be the focus for brokers when South32 reports in August. The other catalyst, a sale of South Africa Energy Coal, is considered unlikely to be resolved at that stage.

-Stock offers mix of cash returns, restructuring and growth initiatives -Yet Macquarie suggests declining alumina, coal and manganese prices put pressure on the outlook -Consensus estimates for South32 and metals prices have been cut significantly

By Eva Brocklehurst

A significant catalyst is looming for South32 ((S32)), as it considers offers for its business South Africa Energy Coal (SAEC). SAEC is the main under-performer for the company, with export coal production -7% below guidance. Otherwise, most operations finished the June quarter broadly in line with guidance.

UBS is encouraged by the quarterly performance, given the operating issues that have occurred over the last few years. The company expects unit costs over FY19 will be slightly higher than guided at Worsley, because of caustic consumption, and at South African manganese, because of higher volumes and trucking. Extra rehabilitation costs have also occurred at SAEC. Hillside and Mozal are expected to be loss-making because of the price versus cost squeeze.

SAEC and capital management are the focus going forward, Credit Suisse suggests, and capital management calculations should take into account the Trilogy option which has not yet been exercised. The broker believes the stock is becoming quite attractive on a 12-month view. UBS expects South32 will exercise the option to retain 50% of Trilogy Metals, for $150m, by January 2020.

The Hermosa project pre-feasibility study is expected to conclude before the end of FY20, while Eagle Downs final investment decision (FID) is still expected by December 2020. Hence, UBS agrees the stock offers an attractive mix of cash returns, restructuring and growth initiatives.

Macquarie reiterates an Underperform rating, suspecting any capital management will be modest and declining alumina, coal and manganese prices continue to put pressure on the outlook.

Morgans, on the other hand, upgrades to Add from Hold, believing the market is extremely biased towards short-term earnings momentum in resources and the stock has been sold off just at a time when the company is approaching a major catalyst.

SAEC

Macquarie had expected the sale of SAEC to be completed by the end of August, which indicates the timing may have slipped. Credit Suisse, too, suspects those expecting a close on this sale by the August 22 results will have to wait a little longer.

Bids were received during the quarter for the divestment of this division and offers are being finalised. The company has promised a further update in the second half of 2019. The book value is around US$75m but the company has noted the carrying value will be reviewed in relation to the bids.

Ord Minnett points out it is possible the business will be reported as a discontinued asset. The broker carries the asset for zero value but suspects the market will react favourably to a sale being completed even at zero, given the likely improvement in the company's environmental, social and governance (ESG) credentials and a lower capital expenditure requirement going forward.

Morgans also values SAEC at close to zero, assuming the company does not recover material proceeds from the sale. The main benefit in the sale, the broker asserts, will be how much the company's competitiveness in terms of margin, cash flow and sovereign risk improve.

Meanwhile, there was a strong quarter at Illawarra Coal, with metallurgical production up 29% and ahead of many estimates. Both the Dendrobium and Appin mines performed well, despite two longwall moves.

Manganese

The main disappointment for brokers was Australian manganese, where an extended wet season caused output to fall -4% short of guidance. This was slightly offset by much stronger volumes from South Africa, where manganese production shipments were 11-12% of Macquarie's expectations. The company is now reviewing the options for its manganese smelters.

Morgans assesses, with the US/China trade war impacting on the stock choices, consensus estimates for both South32 and metal price forecasts have been cut aggressively.

This signals to the broker that the market is being overly conservative, leading to South32 trading on a 4.0x enterprise value/operating earnings (EBITDA) basis for FY20. In addition to divesting SAEC, Morgans envisages an opportunity to divest both the manganese alloy assets and Australian aluminium business.

The latter is considered another difficult energy-intensive business that is not supported by a healthy price environment. The company's management team has been candid about long-term plans to exit some areas and re-orient the business towards base metals, having inherited its original portfolio from parent BHP Group ((BHP)).

FNArena's database has five Buy ratings, one Hold (Ord Minnett) and one Sell (Macquarie). The consensus target is $3.41, signalling 10.9% upside to the last share price. The dividend yield on FY19 and FY20 forecasts is 5.1% and 4.5% respectively.

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Saracen Primed For Expansion

Brokers are modelling an expanded production outlook for Saracen Mineral but concede the stock is already trading ahead of valuations.

-Production aspirations of 400,000 ounces of gold per annum expected to be met -Positive developments expected in the upcoming update -Costs continue to trend lower

By Eva Brocklehurst

Saracen Mineral Holdings ((SAR)) finished FY19 production with a flourish, maintaining its aspiration of 400,000 ounces of gold per annum. Brokers are now modelling an expanded production outlook.

Cash/gold plus investments moved sideways over the June quarter, because of a heavy capital investment phase. Having spent $34m on exploration in the June half, the company has indicated it will provide an updated outlook in the next few weeks.

Canaccord Genuity expects increased reserves, particularly at Carosue Dam/Dervish will underpin a commitment to expanding the mill capacity to 3.2mtpa from 2.4mtpa. Expansion costs of $25m are assumed, implemented over a 12-month month period. Additional ore is likely to be sourced from open pits that have already defined modest reserves, with grades that range between 1.2-2g/t.

Production is forecast to increase in FY20 to 350-370,000 ounces at an all-in sustainable cost (AISC) of $1025-1075/oz. While the FY20 guidance is less aggressive than previously expected Macquarie anticipates the upcoming update on the long-term outlook will contain a number of positive developments.

The broker's call for a production rate of over 400,000 ounces per annum from FY21 is considered a constructive view of what the assets can deliver over that time frame. While incorporating both a premium to net asset value and a 10-new cash flow multiple, Macquarie's target still fall short of the current share price and, as a result, the rating is downgraded to Underperform.

Factoring in the lower-than-expected FY20 guidance reduces the broker's estimates for earnings per share by -14%. A reduced production outlook, versus prior forecasts, for FY21-23 results in an -8% cut to the target, to $3.50.

June quarter production was 88,100 ounces comprising of Thunderbox production at 42,300 ounces and Carosue Dam at 45,800 ounces. The latter was below Macquarie's expectations with mined grade of 2.8g/t the main variant.

However, with the Dervish underground still ramping up and commercial production imminent Canaccord Genuity believes it is hard to be overly critical of the lower output. At this point, the broker does not change assumptions for the Thunderbox, although highlights the potential for an alternative bulk/mining method to improve underground head grades.

Costs continue to trend down in line with the broker's expectations, underpinned by the lower strip ratio and higher grades, which also meant stockpiles doubled to around 68,000 ounces. The Bligh Resources acquisition is also expected to bolster the medium-term production outlook.

Canaccord Genuity envisages the company can sustain a 400,000 ounces per annum production profile from FY22 with a 9-year mine life of which at least seven should be supported by reserves. The broker has a Sell rating and $3.45 target, noting the stock is trading at a healthy premium to valuation.

Citi also has a Sell rating, with a target of $3.30. The broker finds the organic growth story attractive but agrees it does not support the current share price. The company is noted to be forecasting lower costs in FY20 and, Citi assumes, in FY21. The broker also flags the fact that hedging for just under half of the company's estimated production allows leverage to the gold price while locking in a solid margin.

Cash Flowing For Western Areas

Western Areas is currently benefiting from a surge in the nickel price, although there are questions over whether the increase is sustainable in the short term.

-Nickel reserves and resources increase at both Flying Fox and Spotted Quoll -Less than three years remaining for Flying Fox before low-grade option needs to be pursued -Odysseus could provide the answer as Flying Fox declines

By Eva Brocklehurst

Nickel miner Western Areas ((WSA)) is highly leveraged to the nickel price and is currently a beneficiary of the 23% surge in nickel pricing since June. Hence, an improving cash position signals to brokers the funding of the Odysseus project is now more assured.

Going forward, cash may also be boosted by the $33m in proceeds from the sale of shares in Kidman Resources ((KDR)), if the takeover bid by Wesfarmers ((WES)) is completed.

UBS calculates that with spot nickel prices at US$6.60/lb, this implies cash margins for Western Areas of around US$2.00/lb. Yet, while Western Areas is ideally placed for a lift in nickel usage, based on 1-3-year view regarding electric vehicle demand, the broker does not believe the latest surge in nickel prices has fundamental backing.

Hence, there could be a short-term risk of nickel prices returning below US$6/lb in the second half of 2019. Eventually, the broker forecasts a substantial lift in the company's net profit in FY21, driven by nickel price appreciation to US$8/lb.

Updated Reserves/Resources

Western Areas has produced an updated reserve and resource statement for Flying Fox and Spotted Quoll. Reserves and resources have increased at both deposits. Net of depletion, nickel tonnage has increased 9% at Flying Fox while grades improved 6%.

Yet, Credit Suisse was disappointed there was no economic extension found from exploration at Flying Fox, as reserves now support less than three years of remaining life before a low-grade strategy needs to be pursued.

A replacement ore source needs to be defined to use the mill capacity that becomes available as Flying Fox is depleted and, the broker points out, this could be available in the Diggers South area, where there is a permit to mine that is waiting capacity as well as a satisfactory nickel price.

Diggers South has a 2mt reserve at 1.5% nickel for 29,000t that the broker suggests may have a lower expenditure option for extraction. While Diggers is a large-scale project, New Morning is considered a more logical lower-risk opportunity to prove and optimise heap leaching and MREP (mill recovery enhancement project) production, which still needs to be demonstrated commercially.

Credit Suisse notes progress with the MREP is materially behind expectations, as hydrometallurgical challenges continue to be encountered. While not the main focus for production, this process can unlock value from lower grade ore.

On the other hand, exploration was positive at Spotted Quoll, with the company confirming depth extensions. Increases to reserve and resource estimates for Spotted Quoll have driven an increase to Macquarie's assumptions for the life of the mine, with mining expected to finish in the second quarter of FY24.

Catalysts

Production in the June quarter was in line with expectations with nickel in concentrate produced and sold at 5400t and 5900t, respectively. Milled tonnage, grade and recoveries were also broadly within expectations. Western Areas is set to commence offtake discussions for agreements due to expire in early 2020. The outcome of these discussions could represent a key catalyst for the company in FY20.

Meanwhile, Odysseus is on track and on budget, with early works completed. Credit Suisse assesses, with a three-year lead time to first production, the mine could be up and running against a declining mine life at Flying Fox.

Credit Suisse downgrades Western Areas to Neutral from Outperform on valuation. The stock is also trading in line with the UBS valuation that includes full value for Odysseus, which still carries development risk. There are two Buy ratings and four Hold on FNArena's database. The consensus target is $2.53, signalling 7.4% upside to the last share price.

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Fortescue Metals To Peak Soon?

Will iron ore prices peak soon? Several brokers ponder the outlook for Fortescue Metals, with the stock heavily leveraged to the fortunes of the commodity.

-Share price could come under pressure when iron ore prices descend -Record June quarter production, FY20 guidance expected to be met -Strong price realisation, final dividends expected

By Eva Brocklehurst

Speculation over the course of iron ore prices is heating up and the commodity's recent strength could bedevil Fortescue Metals ((FMG)) going forward. Hence, Credit Suisse downgrades to Neutral from Outperform, begrudgingly.

The trigger is the broker's view on the commodity rather than the company, as iron ore prices are expected to peak in the current quarter. In Fortescue Metals' favour, guidance is usually met, volumes are growing and the job of offsetting cost pressures has been accomplished well.

Moreover, the broker calculates that upgrades to the product suite should deliver better margins. Hence, there is no reason to sell the stock. Yet Credit Suisse suspects the share price will come under increasing pressure as iron ore prices descend from lofty heights.

Morgans, yet to update on the quarterly, struggles to justify the share price in value terms, assessing iron ore would need to average US$130/t for the next two years to be supportive. Also, the current earnings upgrade cycle is unlikely to catch up to the share price and so the broker retains a Reduce rating. The main risk, Morgans acknowledges, is an unexpected structural change in the iron ore market.

The broker also believes the company is currently in the ideal position to push into other metals, speculating Fortescue Metals could make a move on a comparatively smaller, mid-cap base metal peer.

UBS, too, is concerned about the sustainability of the iron ore price and maintains a Sell rating. In contrast, Shaw and Partners, not one of the seven brokers monitored daily on the FNArena database, has a Buy rating and $9.98 target and expects the company will stay in a sweet spot for earnings, along with its iron ore peers, for an extended period into 2020.

Change In Sentiment?

Ord Minnett considers the drop in the share price following the quarterly report relates to a change in sentiment towards iron ore markets. This follows slight increases in Vale's production outlook and a minor increase in Chinese port stocks. China's steel production in June was at a another record rate and up 9% year-on-year.

The broker reiterates a Buy rating, assessing the stock offers attractive valuation metrics and strong shareholder returns over the medium term. Ord Minnett expects a record 65% operating earnings (EBITDA) margin next year and a 20% dividend/free cash flow yield based on an achieved price of US$82/t and the spot price around US$100/t.

FY20 guidance is for 170-175mt with costs around US$13.50/t. Processing facilities are expected to be operating more smoothly in FY20 and bottlenecks are now likely to shift to the rail and port, Citi observes. Fortescue Metals is now the lowest cost operator in the Pilbara, the broker adds, and mining strip ratios were a low 1.4x in the quarter.

The company posted record June quarter production and shipped 167mt over FY19. Cash costs were under US$13/t and net debt at the end of the financial year was just US$2.1bn. The next two years will involve heavy capital expenditure but this will leave the business in better shape, Credit Suisse asserts.

Moreover, the company has reiterated its dividend policy and Macquarie suspects there is upside potential for dividends with the FY19 result on August 26. The broker assumes a $0.90 final dividend, $0.60 of which has already been paid. This translates to a 77% payout-out ratio, or 85% including the first half special dividend. Macquarie lifts FY20 and FY21 forecasts for earnings to reflect improved price realisations of 87%.

Seasonality

Iron ore production is typically seasonal, Shaw and Partners adds, with the June quarter invariably the strongest for shipments and the March quarter the most affected by the weather.

The broker is wary of annualising June quarter or June monthly data, noting a recent trend to emphasise a "supply response" in Australia and Brazil and pointing out, yes, there is a supply response - every year. Furthermore, over the next three quarters there will be relatively less iron ore available to customers, as usual, and the "wall of supply" is likely to head into seasonally softer periods.

Citi raises FY19 price realisation estimates and assumes 84% realisation in FY20. The broker assesses 58% iron pricing has moved too high against the benchmark and 62% is now a cheaper iron ore source. In terms of mix, higher grade West Pilbara fines (60% iron) now account for 10% of the company's product mix.

FNArena's database has two Buy, three Hold and two Sell ratings. The consensus target is $8.40, signalling 2.4% upside to the last share price. Targets range from $6.15 (Morgans) to $11.00 (Macquarie).

See also, Will Fortescue Metals Spread More Cash? On May 21 2019

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ESG Focus: What Does Modern Slavery Act Mean For Investors?

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

What Does Modern Slavery Act Mean For Investors?

By Mans Carlsson-Sweeny, Head of ESG research, Ausbil Investment Management

The Modern Slavery Act has recently passed the House of Representatives. In practice, it will introduce reporting requirements for businesses on the risk of slavery in their operations and supply chains. What does this mean for investors and how can investors contribute to positive change on labour rights and other human rights? This paper provides some ideas based on discussions with global leaders. The paper also puts a spotlight on the garment sector in Cambodia, which Ausbil recently visited.

The ‘S’ in ESG is becoming increasingly important

In the past, the ‘S’ in ESG has sometimes been referred to as the ‘soft’ part of ESG. However, in our view, that is not the case and in the last two years we have seen examples of what can happen in cases of improper conduct or when companies have underpaid workers. While the ‘S’ is not always that easy to quantify, research shows that increasingly, the proportion of company value that comes from so-called intangible drivers has increased and from our perspective, a significant part of these intangible value drivers can be classified as ‘S’, such as culture, staff engagement, safety performance and supplier relationships.

The importance of issues such as labour rights and other human rights, including modern slavery, is closely linked with Ausbil’s investment philosophy. Ausbil believes earnings revisions drive share prices and we prefer companies with sustainable earnings and quality management. At the heart of it, if a business model relies on underpaid workers, or even slavery, or weak regulation on social issues, current earnings will unlikely be sustainable. Also, brand damage can lead to loss of sales. However, it is not all about earnings. We see ESG as a proxy for management quality. When a company does not know its own supply chain or does not understand the risks of slavery, it begs the question: what else should we worry about? Also, damaged brands can be costly and time-consuming to restore and can also have internal impacts, such as staff engagement and distraction for management and the board.

In addition, we foresee increased regulatory risk. In addition to companies being exposed for underpaying workers in Australia, leading to a government inquiry into the franchise industry, there is also increased global regulatory focus on forced labour. The UN Sustainable Development Goals aim to eradicate slavery by 2030; with only 12 years remaining we expect there will be increased regulatory activity globally. Offshore, there have also been cases brought by consumers and non-government organisations (NGOs). In 2018, 36 countries were taking steps to address forced labour in business or public supply chains versus only four in 2016 . We’ve already seen the UK Modern Slavery Act (MSA), various initiatives in Europe and more recently, the Modern Slavery Act introduced into Parliament in Australia where it passed the lower house in September 2018.

What is modern slavery and what is the Modern Slavery Act?

Modern slavery includes children working in slavery, forced labour, debt bondage, human trafficking, forced marriages and forced sexual exploitation. As discussed in our investor statement on slavery from 2016, the practice of slavery is often hidden deep in the supply chain and can be difficult to detect even when suppliers have been audited.

It has been estimated that there are 40.3 million people in slavery conditions globally. Slavery is thus potentially more prevalent than ever before in human history, partly driven by migration, repressive regimes and conflict as well as environmental destruction. Of those, 24.9 million are in forced labour. The majority of these are found in Asia. It was also estimated there are 15,000 victims in Australia .

In 2017, the Commonwealth Government of Australia announced its intention to introduce a Modern Slavery Statement (similar to the UK MSA). Ausbil made submissions in support to government and also participated in various workshops with government, the opposition, businesses and NGOs. Following significant consultation, the Modern Slavery Act (MSA) was introduced to parliament in August 2018 and passed the lower house in September. Separately, a Modern Slavery Bill (MSB) passed both houses in New South Wales in June 2018. The intention of both is to mandate companies above a certain threshold level ($100m in consolidated annual revenue for the federal MSA and $50m in NSW) to make publicly available modern slavery statements on an annual basis. Those reporting federally will be exempted from the NSW MSB.

Comparing the UK MSA with the Australian MSA, one significant difference is that the Australian MSA, once passed both houses, will have mandatory reporting requirements (unlike in the UK where reporting organisations can opt out), covering 1) the reporting entity, 2) the structure of the operations and supply chain, 3) describing the risks of modern slavery practices in the operations and supply chains / any entities owned or controlled, 4) actions taken to assess and address modern slavery risks, including due diligence and remediation, 5) how effective those actions have been and 6) the process of consultation with entities owned / controlled and any other relevant information. The mandatory requirement and the fact that the Department of Home Affairs will control the publication of the MSA statements (which makes them comparable), means the Australian MSA has slightly more teeth than the UK version, where companies can opt out.

Ausbil will provide input and feedback on the guidance, which will provide further clarity on the specific reporting requirements. At the time of writing, we understand that companies need to report beyond tier one suppliers in the supply chain and we also understand that, based on the definition of ‘operations’, investors that meet the revenue thresholds will need to report on slavery risk in their portfolio holdings. The earliest we expect anyone would have to report is June 2020.

How can investors spot the risks and promote change?

ESG integration to Ausbil means a) better informed investment decisions and b) active ownership, or engagement on ESG issues. Human rights in supply chains has been a key engagement theme for Ausbil for years and earlier in 2018, Ausbil published an annual ESG engagement report, which detailed the engagement strategy, activities and outcomes in 2017.

Ausbil believes investors have an important role to play and can be part of the solution by encouraging companies to adopt industry best practice with a business rationale and with real life examples. To that end, Ausbil was a major contributor to a recent publication by the Responsible Investment Association Australasia (Investor toolkit – human rights with focus on supply chains).

A key issue with slavery, including forced labour, is that it is a profitable trade for the perpetrators and because of its illegality, it is often hidden deep down in supply chains. However, investors can still assess risks by focusing on a) high-risk sectors and b) identifying other risk flags. The Global Slavery Index estimated that $354 billion at-risk products are imported by G20 countries. The top products at risk of modern slavery are laptops, computers and mobile phones, garments, fish, cocoa and sugarcane. Other industries that are at high risk include mining, construction and building materials. In Australia, the obvious hot spots include, for instance, cleaners, agriculture and horticulture. Investors can also consider a number of other red flags, such as industries prone to sub-contracting, such as oligopolistic industries where there is competition on price and buyer-supplier relationships are highly transactional or where there is high pressure on shorter lead times. Other key indicators include complex and long supply chains with several intermediaries and where supply chains rely on a high proportion of migrant labour and others vulnerable to exploitation. At a more detailed level, other risk flags include labour recruitment agencies, employers withholding passports and forced deductions.

Promoting Human Rights within supply chains – key issues

Many human rights issues are often complex as well as highly intertwined and rather than focusing on modern slavery in isolation, Ausbil believes investors should encourage companies to make progress and adopt industry best practice on a number of underlying issues (these apply widely across many industries). Below is a short summary of some of those:

Map out and risk assess the supply chain: A company that does not understand its own supply chain can be a proxy for poor management quality. We believe, as a starting point, companies need to map out their supply chains as far as possible beyond tier one suppliers, as many of the worst labour rights issues are occurring further down. Companies need to understand their supply chain, not just from a labour rights perspective but to be able to trace products, for example in the event of a product quality issue. Once mapped out, supply chains can be risk assessed by segmentation based on geography and various indices. Supply chains are becoming increasingly complex and it is difficult and costly to do due diligence on every supplier. Focus on the ability to influence: a responsible sourcing code of conduct might stipulate criteria that a supplier needs to live up to, but unless the buyer is in a position to influence suppliers they might not comply. Suppliers can be incentivised by rewarding those that improve with more business. Also, because of the complexity of global supply chains, consolidation can lead to both better visibility and oversight over the supply chain. Consolidation can also improve influence and incentivise suppliers to enforce the labour standards further down in the supply chain in tier two and beyond where a buyer has no direct relationship. Reduce reliance on only audits and focus on building long-term strategic supplier relationships: many companies publish audit statistics but often they only cover the first tier of the supply chain and not beyond where the worst issues are typically found, which means that audits might only be scratching the surface. Also, audits typically only give a snapshot view of a factory at a particular point in time. Audits, particularly pre-announced ones, can be a waste of money and of limited use when it comes to identifying forced labour and sexual harassment. The Rana Plaza building in Dhaka, Bangladesh, which collapsed in April 2013 and killed over 1,100 garment workers had been audited beforehand, but the audit scope did not cover the structural integrity of the building. Audits are a start and can be complementary, but it's what happens after the audit that is more important, namely the corrective action plan. Leaders are moving away from audits only and are focusing more on know your supplier (KYS) and spending time with key suppliers on a regular basis. Staff training and alignment of KPIs between ethical sourcing and procurement teams: while many buyers have responsible sourcing teams and codes of conduct for suppliers, our discussions with suppliers in Asia indicate that their goals are often misaligned with those of the procurement team (mainly on price). Combined with closer supplier relationships, alignment of responsible sourcing standards with buying teams, as well as training of buying teams (and suppliers and auditors) on responsible sourcing, can reduce the risk of subcontracting of production by suppliers and help them invest in factory improvements with greater confidence. Late changes to orders with demands for short lead times is a common issue that often leads to subcontracting or suppliers cutting corners on labour rights. Increase transparency and collaboration: leaders collaborate with other stakeholders to better understand the risk. Because many of the issues are of a systemic nature, they require a systemic approach and multi-stakeholder initiatives. Two key underlying issues across a wide range of sectors are the lack of living wages, namely a wage that meets basic needs and which may be very different from a local minimum wage, and freedom of association. The latter has been found to be a common denominator for many factory disasters, notably in Bangladesh where workers lack union representation. While individual companies might have limited ability to influence behaviour, shared best practice and a collaborative approach on key labour rights issues can result in change. For example, buyers from the same factory engaging with suppliers on the same issues. Many responsible sourcing initiatives have sprung up in recent years, particularly in the apparel industry, but not all have focused on transparency. Nevertheless, it is increasingly clear that transparency contributes to progress. For instance, the Better Factories Cambodia programme has disclosed factory compliance on critical issues for years, which has led to significant improvements in conditions. Increased use of technology and grievance mechanisms: In recent years, a number of third party platforms have emerged that improve transparency, facilitate mapping / risk assessment of supply chains and avoid duplicate audits (saves costs and reduces audit fatigue for suppliers). These can also be helpful tools for investors. Better use of technology can also address the limitations of audits, such as providing apps for workers to report on issues that might not be covered by a standard factory audit, such as sexual harassment. Companies with remedial plans for when human rights issues are found in supply chains can both create positive goodwill with external stakeholders and strengthen their ties with suppliers. Blockchain and other technology can also identify potential cost savings in the supply chain, which could potentially free up capital for higher wages.

Recent trends in responsible sourcing

A number of companies we spoke to in the most recent reporting season had begun to prepare for MSA reporting in Australia, before the Act was introduced in Parliament, starting with mapping out their supply chains and risk assessing suppliers. Leaders are also increasingly acknowledging the limitations of factory audits and certification. As discussed above, audits might identify issues but may not solve them because they fail to pick up on certain underlying issues. Failing to do so can result in supply chain disruption.

On a positive note, leaders are increasingly acknowledging that supply chain consolidation is key not only to reducing supply chain complexity but also to being able to resolve some of the key issues. Also, we're seeing increased collaboration between buying companies and between buying companies and NGOs.

Six to seven years ago, there was a trend of brand companies moving away from the use of agents to direct sourcing instead. While this reduces the fees paid to auditors and also improves the potential visibility over the supply chain, lately there has been a general trend of buying companies using agents for their sourcing again. The drivers seem to be pressures on shorter lead times and increased supply chain complexity.

One area where little progress has been made is the alignment of ethical sourcing and pricing despite years of focus on strengthening responsible sourcing practices. It is still common for suppliers to complain that deals are struck based on price only and cite conflicting interests between that and responsible sourcing demands.

Spotlight on Cambodia's garment industry and the prevalence of sexual harassment

The nature of the workforce in China is changing dramatically, which is adding to existing labour shortages and also continued wage inflation. As a result, Chinese manufacturers are increasingly focusing on automation, and manufacturing is also increasingly moving out of China to other south-east Asian countries, often to Chinese-owned factories. One such country is Cambodia where garments are a key export industry and employ approximately 600,000 workers, mainly migrant workers (85% of whom are women). The investment by China in Cambodia is increasing China's influence in the country.

Ausbil visited garment factories in Phnom Penh in September 2018. Common issues for buyers in Cambodia include electricity costs, lack of productivity and long lead times as well as the lack of vertical integration. Comparing

Cambodia to Bangladesh, one major difference is that very few factories are owned by domestic operators in Cambodia (the complete opposite to Bangladesh). Yet, both countries share one common feature: the lack of vertical integration. In other words, both countries are mainly focused on the cutting and sewing stage of the supply chain, which means price, particularly labour cost, is a key differentiator. In contrast, China has significant vertical integration in the garment industry, which, along with superior productivity, is a key reason why China has maintained its competitiveness despite significant wage inflation for many years. In Cambodia, the average take-out pay is above US$200 per month, which is significantly higher than in Bangladesh and wages are expected to increase further in Cambodia.

An interesting initiative is the Action, Collaboration, Transformation (ACT), which is a collaboration of between approximately 20 global brands / retailers and trade unions to achieve living wages for workers through collective bargaining at industry levels. ACT has met with key players in Myanmar, Turkey, Vietnam and Cambodia. In Cambodia, ACT has engaged with employers and trade unions and a memorandum of understanding has been signed by all ACT member brands with the union IndustriALL. As part of ACT, brands will make countries with a collective bargaining agreement at industry level a preferred destination for sourcing and investment for a defined period of time. They also agree to incorporate higher wages as a cost item in their purchasing price calculations. In September 2018, ACT was preparing for a meeting with Cambodian partners to discuss a labour costing model, transparent ways of monitoring ACT member brand commitments and a joint conflict resolution approach.

The International Labour Organisation’s (ILO) Better Factories programmes originated in Cambodia, which has traditionally been seen as relatively progressive on labour rights. This has historical roots from when Cambodia was open to advice from international stakeholders in the wake of the Pol Pot regime. For instance, the country is in advanced negotiations on national collective bargaining, one of the key underlying issues in Asian supply chains. However, at the time of writing, political uncertainty in Cambodia, following the dissolving of the opposition, might derail that process. In turn, that could make the supply chain more volatile again for those who source from there. Sanctions from overseas could also be a major blow to the industry.

Ausbil visited a number of factories together with CARE, which is an international development organisation fighting global poverty with a special focus on working with women and girls. CARE sheds light on the productivity loss from sexual harassment, which is rarely picked up by regular factory audits. Behaviours can include physical harassment and physical violence / assault, verbal and non-verbal harassment. CARE found, through interviews and focus groups, that nearly one in three female garment factory workers report experiencing sexually harassing behaviours. This also has a monetary cost: the estimated productivity cost of sexual harassment in the garment industry in Cambodia is US$89 million per year. This is equivalent to 0.52% of Cambodia’s GDP in 2015. This is based on indirect costs of lower productivity, revenue loss and missed days of work based on both factory and worker perspectives. Presenteeism generated the highest costs to productivity. The data that found that women felt there was no other option for them but to attend work, despite harassment, as absenteeism was not an option. In addition to sexual harassment, CARE also focuses on hygiene and nutrition for workers through educational programs. Tangible benefits from improvements in these areas include reduced sick leave, lower absenteeism and better productivity. It has also reduced the number of workers fainting in factories, which has been a big issue in Cambodia in the past.

Weekly Ratings, Targets, Forecast Changes

By Rudi Filapek-Vandyck, Editor FNArena

Guide:

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

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

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

Summary

Period: Monday July 15 to Friday July 19, 2019 Total Upgrades: 7 Total Downgrades: 15 Net Ratings Breakdown: Buy 38.79%; Hold 44.46%; Sell 16.75%

Stockbroking analysts haven't been loafing around these past few weeks, updating forecasting models as the August reporting season approaches, but the news has remained negatively biased as downgrades continue outnumbering upgrades, and with earnings forecasts, on balance, continuing to slide further downwards.

For the week ending Friday, 19th July 2019, FNArena registered seven upgrades for individual ASX-listed entities; again outnumbered by 15 downgrades.

Total numbers for the seven leading stockbrokerages monitored daily are now Buy 38.79%, Hold 44.46% and Sell 16.75%. The gap between total Buy ratings and Neutral/Holds has seldom been this wide, if ever.

In a rare expression of unity, all upgrades moved to Buy with Aristocrat Leisure, ANZ Bank, Santos and Sydney Airport among the lucky receivers. Among the downgrades, we find many stocks that performed well in the first six months of calendar 2019; Carsales, Cochlear, CSL, Magellan Financial, Ramsay Health Care, REA Group and ResMed.

Others that equally received a downgrade last week include Cimic Group, Data#3, G8 Education and Galaxy Resources.

A handful of stocks enjoyed further increases to price targets, with Perseus Mining in the week's lead, followed by nib Holdings, Aristocrat Leisure and Magellan Financial. There are only four names in the opposite table, but the average reduction also looks decisively bigger. The week's largest cut befell Galaxy Resources, followed by Cimic Group, Ebos Group and G8 Education.

Earnings estimates received notable boosts for Nearmap, Healius, Challenger, Austal and numerous others. But, again, the reductions elsewhere look a lot larger, led by Perseus Mining and Galaxy Resources, followed at significant distance by Michael Hill, Woodside Petroleum, OZ Minerals, and others.

It's early days still in the US' Q2 reporting season, and macro dynamics will continue dominating overall investor sentiment, but by week's end local attention will increasingly also include profits, margins and forward guidance delivered by Australian companies. ResMed unofficially kicks off the August reporting season on Friday, with Credit Corp and Rio Tinto not far behind.

Cimic Group's result release last week proved disappointing. Outside of iron ore miners, analysts' expectations are rather low, but this doesn't mean it'll be easier for Australian companies to deliver a positive surprise.

Upgrade

ARISTOCRAT LEISURE LIMITED ((ALL)) Upgrade to Overweight from Equal-weight by Morgan Stanley .B/H/S: 7/0/0

Morgan Stanley asserts Aristocrat Leisure does not need to outperform to succeed in digital. The company's land-based success and scale provide a competitive advantage, despite growth moderating in this area.

Morgan Stanley adjusts estimates to allow for top-line growth from stronger digital growth, eases back margins to account for digital's lower margins and adjusts for a lower tax rate.

All up, estimates for earnings per share are reduced by -1% in FY19 and raised by 3% for FY20. Rating is upgraded to Overweight from Equal-weight and the target is raised to $35 from $29. Industry view: Cautious.

ATOMOS LIMITED ((AMS)) Upgrade to Add from Hold by Morgans .B/H/S: 1/0/0

Following increased working capital flexibility and factoring in the recent launch of the Neon range, Morgans upgrades revenue estimates by 5% across FY20/21.

The broker believes the recent momentum in the company's products and the relatively fixed cost base should mean there is upside to forecasts upon successful execution. Given the returns on offer the rating is upgraded to Add from Hold.

The broker suggests additional partnerships can move the dial in terms of revenue/earnings uplift. Target is raised to $1.63 from $1.42.

AUSTRALIA & NEW ZEALAND BANKING GROUP ((ANZ)) Upgrade to Add from Hold by Morgans .B/H/S: 1/4/2

Morgans upgrades to Add from Hold because of recent share price weakness. The broker believes stimulus initiatives announced by APRA (Australian Prudential Regulatory Authority), for an additional capital add-on of $500m for operational risk, to be applied until the banks have completed their planned remediation, will de-risk the earnings outlook for the sector.

Morgans considers the initiatives are positive for the outlook for system credit growth and asset quality. The broker expects the major banks to become more attractive to investors from a yield perspective as government bond yields fall.

The broker expects an -18 basis points reduction in the CET1 ratio for ANZ Bank but it is still likely to be above the unquestionably strong benchmark of 10.5%. Target is steady at $29.

ELDERS LIMITED ((ELD)) Upgrade to Add from Hold by Morgans .B/H/S: 1/0/0

Elders will acquire Australian Independent Rural Retailers for $187m. The acquisition will be funded via cash and scrip. Morgans considers the purchase price reasonable, given the size of the group.

This will mean Elders has a presence in the wholesale channel, and the acquisition fills a gap in Queensland and NSW as well as increasing the company's presence in the higher-margin animal health sector.

Morgans calculates the mid point of synergies is 8.9% accretive to earnings per share in FY21. Rating is upgraded to Add from Hold. Target is raised to $7.30 from $6.71.

OCEANAGOLD CORPORATION ((OGC)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 3/2/0

Macquarie visited OceanaGold's NZ operations and came away expecting a substantial extension to mine life at Macraes and ongoing exploration at Waihi to offer production upside.

The broker sees NZ as the key earnings driver in the medium term, and expects the stock's discount to the sector to unwind as projects gain momentum.

Upgrade to Outperform. Target unchanged at $5.00.

SANTOS LIMITED ((STO)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 3/4/0

Macquarie upgrades to Outperform from Neutral following the recent pull back in the shares. Target is raised to $8.20 from $7.60.

Several catalysts are expected to de-risk future large-scale development opportunities over the second half including flow-testing of Dorado-3, MacArthur basin drilling, potential Narrabri approvals and the 2019 investor briefing.

SYDNEY AIRPORT HOLDINGS LIMITED ((SYD)) Upgrade to Add from Hold by Morgans .B/H/S: 3/1/3

Accepting a lower-for-longer scenario for bond yields, Morgans has upgraded to Add from Hold. Short term forecasts have been reduced a little, but the analysts point out the small changes have a compounded impact further out.

Growth in dividends per share is now projected to decline to 2% only per annum across FY20-FY23. Lower bonds overshadow all of that, with the price target jumping $1.10 to $8.71.

Downgrade

CARSALES.COM LIMITED ((CAR)) Downgrade to Reduce from Add by Morgans .B/H/S: 5/1/1

Following a strong share price performance, stockbroker Morgans has decided it's time to downgrade Carsales to Reduce from Add, representing a double-step downgrade in its ratings universe.

Looking towards FY20, Morgans finds the company's growth is most likely to consist of single-digit percentage growth and in this context the current valuation is seen as overly rich.

Morgans retains a positive view on Carsales' long-term prospects, but succumbs to the observation that, short-term, the valuation seems to have moved well-ahead of fundamentals. Price target $12.49 (unchanged). Forecasts have been left untouched.

CIMIC GROUP LIMITED ((CIM)) Downgrade to Underperform from Neutral by Credit Suisse .B/H/S: 1/2/1

First half results missed Credit Suisse estimates, largely at the revenue line. Cash conversion step down to 52% versus the levels of 112% witnessed on an annual basis since 2014.

Management attributed this to a change in the business mix, as large infrastructure work was completed and there were a higher proportion of alliance-style contracts with less opportunity for early cash receipts.

Credit Suisse lowers the target to $35 from $46 and downgrades to Underperform from Neutral. The broker reduces 2019 net profit forecasts by 8%.

COCHLEAR LIMITED ((COH)) Downgrade to Sell from Neutral by Citi .B/H/S: 0/2/4

Citi expects net profit in FY19 of $275m, at the top end of guidance. The broker suspects market growth in North America will be lower than the prior corresponding period as Cochlear may have been more focused on protecting market share.

Net profit is expected to be up 14% in FY20. Given the increase in the share price the broker downgrades to Sell from Neutral. Target is steady at $198.

CSL LIMITED ((CSL)) Downgrade to Neutral from Buy by Citi .B/H/S: 3/4/0

Citi downgrades to Neutral from Buy on recent share price appreciation. The target is increased slightly to $239.60 from $236.60.

The main issues during reporting season are expected to be centred on immunoglobulin market share gains. The broker forecasts FY19 net profit of US$1.94bn, slightly ahead of guidance.

Data#3 Limited ((DTL)) Downgrade to Hold from Add by Morgans .B/H/S: 0/1/0

Data#3 has released revised guidance suggesting FY19 profit will be up 28%, 11% ahead of Morgans' forecast. The broker had flagged upside were there to be no election slowdown, and neither the NSW or federal elections produced a slowdown.

The broker rates the company highly but after a 52% rally over twelve months, downgrades to Hold. Target rises to $2.48 from $2.25.

G8 EDUCATION LIMITED ((GEM)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 3/2/0

Data suggest occupancy trends are improving in the sector post Child Care Subsidy implementation, but Macquarie expects this tailwind to ease. Supply growth is persisting though moderating.

The broker believes G8 Education is doing the right things regarding operational improvement, but it will take time to turn the ship around. It is also unlikely the company will be given the benefit of the doubt on a second half skew when it reports first half earnings, Macquarie suggests. Downgrade to Neutral. Target falls to $2.80 from $3.45.

GALAXY RESOURCES LIMITED ((GXY)) Downgrade to Neutral from Buy by Citi .B/H/S: 2/3/1

Operations were strong at Mount Cattlin in the June quarter, with spodumene production up 35% quarter on quarter. Full year 2019 production guidance is unchanged at 180-210,000t.

Citi believes spodumene has the weakest fundamentals within the lithium supply chain because of low barriers to entry and the dependence on conversion capacity. There is also excess supply in the near term.

The company's current earnings are 100% exposed to spodumene which presents a downside risk to forecasts. Citi downgrades to Neutral from Buy and reduces the target to $1.60 from $2.70.

MAGELLAN FINANCIAL GROUP LIMITED ((MFG)) Downgrade to Underperform from Neutral by Macquarie .B/H/S: 0/4/3

June quarter funds management performance was supported by a strong market, albeit not as strong as March, Macquarie notes, and 1-8% increases in funds under management across the sector. Magellan was the only major manager to experience funds inflows, while Perpetual suffered the biggest outflows.

Magellan continues to deliver a strong market performance but retail inflows are stabilising and Macquarie believes the share price has run too hard. Target rises to $45 from $39. Downgrade to Underperform.

NIB HOLDINGS LIMITED ((NHF)) Downgrade to Sell from Neutral by Citi .B/H/S: 0/5/2

Citi marks to market forecasts to allow for strong equity markets in the second half and the fall in bond yields. The broker now allows for 2.85% rate increases for the next two years but also for a slower reduction in net margins.

The broker continues to expect a solid FY19 result but wonders whether the relief rally following the election result has gone too far. Rating is downgraded to Sell from Neutral and the target increased to $7.05 from $5.85.

PERSEUS MINING LIMITED ((PRU)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 1/2/0

Perseus' June Q saw weaker grades at Edikan, with Sissingue in line. Management has guided to flat production in FY20, as expected, weighted to the second half. The recent trend of cost reduction is expected to continue.

Despite weaker production, deleveraging of the balance sheet continues. Macquarie nonetheless downgrades to Neutral after a strong share price run. Target unchanged at 70c.

REA GROUP LIMITED ((REA)) Downgrade to Reduce from Add by Morgans .B/H/S: 3/2/1

The shares are now trading well above Morgans' valuation and the rating is downgraded to Reduce from Add. REA Group shares have risen 21% since the broker last reported on the stock in May.

Morgans suspects there will be near-term disappointment if the FY20 outlook commentary at the results on August 9 is subdued, or even negative. The broker likes the longer term story but considers the valuation stretched. Target is steady at $91.94.

RAMSAY HEALTH CARE LIMITED ((RHC)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 0/6/1

Macquarie notes Ramsay Health Care's NHS volume growth in the UK remains above sector average, but strong prior periods will be cycled over the balance of 2019.

Earnings growth into FY20 will be supported by incremental brownfield contributions and more favourable tariff outcomes in the UK and France.

But it's all now captured in the price, hence Macquarie pulls its rating back to Neutral. Target unchanged at $75.

RESMED INC ((RMD)) Downgrade to Neutral from Buy by UBS .B/H/S: 3/3/1

The stock has performed strongly and the company will report its results on July 26. UBS expects a continuation of strong mask and accessory revenue growth in FY20, up 9% in the Americas and 11% for the rest of the world.

UBS downgrades to Neutral from Buy. Target is raised to US$122 from US$119. US industry feedback remains positive based on re-supply and the 2021 competitive bidding round is the next hurdle, in the broker's opinion.

SYRAH RESOURCES LIMITED ((SYR)) Downgrade to Underperform from Outperform by Macquarie .B/H/S: 1/2/1

June Q production and costs at Balama both missed Macquarie's forecasts, while sales were in line. Improving production and product mix remain key to stabilising Syrah's balance sheet, the broker suggests.

Macquarie has also pushed back its timing expectation for the Battery Anode Material project, which is key to longer term valuation. Downgrade straight to Underperform from Outperform. Target falls to 90c from $1.20.

WESTERN AREAS NL ((WSA)) Downgrade to Neutral from Outperform by Credit Suisse .B/H/S: 2/4/0

Credit Suisse notes the June quarter production met FY19 in forecasts. Odysseus is on target with early works completed. The broker expects FY20 guidance with the FY19 result.

Rating is downgraded to Neutral from Outperform on valuation and the target is lowered to $2.45 from $2.50.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 ARISTOCRAT LEISURE LIMITED Buy Neutral Morgan Stanley 2 ATOMOS LIMITED Buy Neutral Morgans 3 AUSTRALIA & NEW ZEALAND BANKING GROUP Buy Neutral Morgans 4 ELDERS LIMITED Buy Neutral Morgans 5 OCEANAGOLD CORPORATION Buy Neutral Macquarie 6 SANTOS LIMITED Buy Neutral Macquarie 7 SYDNEY AIRPORT HOLDINGS LIMITED Buy Neutral Morgans Downgrade 8 CARSALES.COM LIMITED Sell Buy Morgans 9 CIMIC GROUP LIMITED Sell Neutral Credit Suisse 10 COCHLEAR LIMITED Sell Neutral Citi 11 CSL LIMITED Neutral Buy Citi 12 Data#3 Limited Neutral Buy Morgans 13 G8 EDUCATION LIMITED Neutral Buy Macquarie 14 GALAXY RESOURCES LIMITED Neutral Buy Citi 15 MAGELLAN FINANCIAL GROUP LIMITED Sell Neutral Macquarie 16 NIB HOLDINGS LIMITED Sell Neutral Citi 17 PERSEUS MINING LIMITED Neutral Buy Macquarie 18 RAMSAY HEALTH CARE LIMITED Neutral Buy Macquarie 19 REA GROUP LIMITED Sell Buy Morgans 20 RESMED INC Neutral Buy UBS 21 SYRAH RESOURCES LIMITED Sell Buy Macquarie 22 WESTERN AREAS NL Neutral Buy Credit Suisse Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 OGC OCEANAGOLD CORPORATION 50.0% 30.0% 20.0% 5 2 ALL ARISTOCRAT LEISURE LIMITED 100.0% 83.0% 17.0% 7 3 ANZ AUSTRALIA & NEW ZEALAND BANKING GROUP -14.0% -29.0% 15.0% 7 4 STO SANTOS LIMITED 43.0% 29.0% 14.0% 7 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 GXY GALAXY RESOURCES LIMITED 8.0% 42.0% -34.0% 6 2 PRU PERSEUS MINING LIMITED 33.0% 67.0% -34.0% 3 3 WSA WESTERN AREAS NL 33.0% 67.0% -34.0% 6 4 REA REA GROUP LIMITED 21.0% 50.0% -29.0% 7 5 CAR CARSALES.COM LIMITED 57.0% 86.0% -29.0% 7 6 CIM CIMIC GROUP LIMITED -13.0% 13.0% -26.0% 4 7 GEM G8 EDUCATION LIMITED 60.0% 80.0% -20.0% 5 8 NHF NIB HOLDINGS LIMITED -29.0% -14.0% -15.0% 7 9 COH COCHLEAR LIMITED -64.0% -50.0% -14.0% 7 10 CSL CSL LIMITED 36.0% 50.0% -14.0% 7 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 PRU PERSEUS MINING LIMITED 0.723 0.680 6.32% 3 2 NHF NIB HOLDINGS LIMITED 6.043 5.733 5.41% 7 3 ALL ARISTOCRAT LEISURE LIMITED 33.114 31.717 4.40% 7 4 MFG MAGELLAN FINANCIAL GROUP LIMITED 43.436 42.579 2.01% 7 5 STO SANTOS LIMITED 7.106 6.974 1.89% 7 6 COH COCHLEAR LIMITED 175.129 172.414 1.57% 7 7 RMD RESMED INC 17.007 16.765 1.44% 7 8 WSA WESTERN AREAS NL 2.525 2.492 1.32% 6 9 CSL CSL LIMITED 212.829 210.686 1.02% 7 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 GXY GALAXY RESOURCES LIMITED 1.742 2.125 -18.02% 6 2 CIM CIMIC GROUP LIMITED 43.495 48.365 -10.07% 4 3 EBO EBOS GROUP LIMITED 23.035 24.070 -4.30% 4 4 GEM G8 EDUCATION LIMITED 3.432 3.562 -3.65% 5 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 NEA NEARMAP LTD -0.867 -1.100 21.18% 3 2 HLS HEALIUS LIMITED 15.566 14.423 7.92% 5 3 CGF CHALLENGER LIMITED 52.786 50.029 5.51% 7 4 ASB AUSTAL LIMITED 15.433 14.700 4.99% 3 5 AQG ALACER GOLD CORP 38.041 36.800 3.37% 3 6 NHF NIB HOLDINGS LIMITED 33.257 32.243 3.14% 7 7 AMP AMP LIMITED 18.443 17.929 2.87% 7 8 STO SANTOS LIMITED 55.591 54.052 2.85% 7 9 IAG INSURANCE AUSTRALIA GROUP LIMITED 43.186 42.100 2.58% 7 10 MYX MAYNE PHARMA GROUP LIMITED 1.288 1.258 2.38% 4 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 PRU PERSEUS MINING LIMITED -0.717 1.433 -150.03% 3 2 GXY GALAXY RESOURCES LIMITED -5.687 -3.011 -88.87% 6 3 MHJ MICHAEL HILL INTERNATIONAL LIMITED 5.225 5.925 -11.81% 4 4 WPL WOODSIDE PETROLEUM LIMITED 211.591 238.482 -11.28% 7 5 OZL OZ MINERALS LIMITED 54.634 61.354 -10.95% 7 6 WHC WHITEHAVEN COAL LIMITED 54.200 57.420 -5.61% 7 7 AWC ALUMINA LIMITED 20.906 22.114 -5.46% 6 8 S32 SOUTH32 LIMITED 29.924 31.432 -4.80% 7 9 CIM CIMIC GROUP LIMITED 246.775 255.875 -3.56% 4 10 OGC OCEANAGOLD CORPORATION 17.710 18.284 -3.14% 5 Technical limitations

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

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Uranium Week: Focus Shifts

A decision on 232 may have finally have been made, but now a US working group has 90 days to report back on the entire US nuclear fuel cycle.

-U3O8 spot price spike fades -National security remains an issue -US working group thus formed

By Greg Peel

Two Friday's ago, the uranium market learned that President Trump had made a decision with regard section 232 and the mandated purchase of US domestic uranium supply, but did not yet know what that decision was. The market knew, nonetheless, that a decision either way would at least remove the uncertainty that had been hanging over the nuclear power industry for over a year.

That uncertainty had kept utilities out of the market, and led to the spot uranium price languishing once more following its revival into 2018. Assuming a return of utility interest, traders jumped in and pushed the spot price up US$1.00 to US$25.50/lb.

When it was revealed, over the following weekend, that Trump had rejected the Department of Commerce's recommendation, and that no mandated purchases or tariffs on foreign uranium imports would be forthcoming, traders initially pushed up the spot price another US50c to US$26.00/lb early last week.

But by week's end, that price had fallen back -US75c. Industry consultant TradeTech's weekly spot price indicator closed the week at US$25.25/lb, down -US25c for the week.

The problem is one uncertainty has been replaced with another.

The Whole Picture

Republican senator for Wyoming, John Barrasso, was indignant over the president's 232 decision, saying "America should not rely on Vladimir Putin and his satellites to supply our uranium. It's dangerous and unacceptable".

Is America relying on Russia, Kazakhstan and Uzbekistan for uranium supply, or is that supply simply cheaper than US supply? For when uranium prices began falling to historical lows from a brief post-Fukushima recovery to US$40/lb in 2014, uranium production in the US and Canada fell in response, while state-owned producers, including the former Soviets and China, kept plugging on. Result? Cheaper supply from outside North America.

Kazakhstan is the world's biggest uranium producer. Russia is sixth and Uzbekistan seventh. Despite reduced production due to lower prices, US ally Canada remains in second place, and US ally Australia comes in third. Despite its major nuclear power expansion program, supply-wise China comes in only at eighth, ahead of the US at ninth, where supply has also been curtailed.

In other words, if uranium supply were to become a matter of national security, could not US and Canadian producers simply ramp up again, along with Australia, to make up for lost imports?

Meanwhile, the Ohio Senate passed a bill last week that endorses financial subsidies for two nuclear power plants in the state that will otherwise retire early given the operator has filed for bankruptcy. The Ohio House has yet to pass the bill, but the Senate's decision highlights that even using cheap foreign imports of uranium, the US nuclear power industry is no longer commercially viable without government assistance.

And that may need to include federal government assistance.

There have been various declarations by several parties over the past few years that in order to ensure secure energy supply, a robust US nuclear power industry must be retained alongside gas-fired and renewable power sources.

Now there's your "national security".

It is thus of little surprise President Trump has immediately followed his 232 decision with the announcement a Nuclear Fuel Working Group will be formed to study the entire nuclear fuel cycle, from mining to electricity.

The Group will be chaired by head security advisor John Bolton and head economic advisor Larry Kudlow, and feature representatives from various government departments and agencies.

The Group has 90 days to produce its report. Here we go again.

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

The Short Report

Guide:

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

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

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

Summary:

Week ending July 18, 2019

Last week saw the ASX200 begin its run towards a new high.

Activity in short position movements picked up a bit last week. Some of those reds and greens below are just bouncing back and forth between brackets but there were a few more significant movements.

Longstanding table-topper Syrah Resources ((SYR)) has been usurped by Nufarm ((NUF)), not because Nufarm shorts much increased but because Syrah shorts fell to 15.6% from 19.3%. See below.

While graphite might be back in favour, lithium is not, with all of Galaxy Resources ((GXY)), Orocobre ((ORE)) and Pilbara Minerals ((PLS)) seeing short increases.

I have noted how Speedcast International ((SDA)) shorts had dropped the past couple weeks following the company's profit warnings and share price plunge. Speedcast shot back up to 10.4% last week from 8.9%, assuming accurate data from ASIC.

I have been following the progress of Hub24 ((HUB)) quietly up the table. It snuck into the 10%-plus shorted bracket last week.

Big movers otherwise include JB HiFi ((JBH)), to 11.7% from 13.9%, AMP ((AMP)), to 8.8% from 7.3%, and Super Retail ((SUL)), to 6.0% from 7.9% (down).

See below.

Weekly short positions as a percentage of market cap:

10%+ NUF 18.6 BAL 16.6 GXY 15.8 ING 15.8 ORE 15.7 SYR 15.6 NXT 13.2 BWX 12.1 PLS 11.8 JBH 11.7 MTS 10.6 SDA 10.4 BIN 10.3 DMP 10.2 HUB 10.0

In: SDA, HUB

9.0-9.9

BGA, HVN, IFL, RWC, CGC

In: IFL, RWC, CGC Out: HUB, SGM 8.0-8.9%

IVC, SGM, PPT, AMP, CSR, WSA, BKL, KGN

In: SGM, AMP, WSA Out: SDA, IFL, CGC, RWC

7.0-7.9%

MYR, BOQ, CGF, SUL, ELD

In: ELD Out: WSA, AMP, SUL

6.0-6.9%

DCN, GMA, NEC, A2M, SUL

In: SUL Out: ELD, GWA

5.0-5.9%

GWA, COE, MSB, LNG, SXY, CLQ, CTD, OML

In: GWA Out: CTD Movers & Shakers

Graphite miner Syrah Resources posted a positive quarterly production report last week, featuring increased sales and lower costs, and sparking a solid share price rally.

Clearly short-covering had a part in that rally, given Syrah shorts fell to 15.6% from 19.3%.

Given no new news out of either JB Hi-Fi or Super Retail over the week, we can only assume short position falls to 11.7% from 13.9% and 6.0% from 7.9% have been inspired by rallies in both stocks, reflecting the retail sentiment boost provided by the election result, tax cuts and RBA rate cuts.

Professor Brian Cox seems to be on Aussie TV every time you turn it on, being best known as the keyboard player from D:Ream, who once sang “Things can only get better”. Clearly Brian does not have shares in AMP.

The embattled wealth manager/insurer had set its own d:reams on selling off the farm to pay for cleaning up the carnage left behind, only to find the planned sale of its Life division kyboshed by the Kiwis. AMP may need to raise new equity.

Hands up?

AMP shorts rose to 8.8% from 7.3%.

ASX20 Short Positions (%)

Code Last Week Week Before Code Last Week Week Before AMC 1.3 1.5 RIO 4.7 4.5 ANZ 0.7 0.5 S32 0.9 0.9 BHP 2.8 2.8 SCP 0.6 0.8 BXB 0.2 0.1 SUN 0.4 0.4 CBA 1.1 1.1 TCL 0.9 0.9 COL 1.4 1.4 TLS 0.4 0.4 CSL 0.5 0.4 WBC 1.3 1.3 IAG 0.7 0.8 WES 1.5 1.4 MQG 0.9 0.8 WOW 1.4 1.4 NAB 0.6 0.5 WPL 0.7 0.7 To see the full Short Report, please go to this link

IMPORTANT INFORMATION ABOUT THIS REPORT

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

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

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

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

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

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

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

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

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

The Wrap: Debt Collectors, Banks & Consumers

Weekly Broker Wrap: debt collectors; banks; consumers; and housing construction.

-Debt collection industry flush with funds -Open banking likely to put pressure on industry returns -Consumers, generally, expect income and expenditure to grow -Significant weakness still ahead for building material providers

By Eva Brocklehurst

Debt Collectors

The Australian Competition and Consumer Commission has started proceedings against debt collection industry participant Panthera Finance. JPMorgan highlights debt collection practices as critically important, given the agency either represents or technically owns the debt originated by customers.

While the balances in this particular case are small, the potential damage to reputation caused by an adverse ruling could affect future dynamics of the purchased debt ledger (PDL) market. Proceedings were lodged on July 23 and the allegations involve complaints over the last two years about the company's activities.

Canaccord Genuity finds, when it comes to future returns in the debt collection industry, access to capital is the key determinant. And they're flush. Credit Corp ((CCP)) has recently procured $140m from a capital raising and Collection House ((CLH)) has Balbec Capital willing to fund its book.

However, for the former, the broker suspects forecasts are optimistic and investors may be disappointed if they assume the US earnings trajectory will be anything but slow.

Collection House, meanwhile, has bought numerous legacy books and ramped up its investment in New Zealand. While there is an overhang from a dissident shareholder selling down, the asset mix and earnings outlook appear markedly better.

Pioneer Credit ((PNC)) appears to have turned around. Canaccord Genuity is keen to learn how this occurred, as well as receive an update on corporate activity when the company reports.

The broker also notes private equity is taking up distressed books across the broader financial services sector. As an example, one firm which has been eyeing a $10m receivables book has revealed that there were 16 bidders for the asset.

Banks

Macquarie believes major banks are likely to continue losing market share. Open banking, where third parties can build application services around the financial institution, is likely to put pressure on industry returns, with the greatest threat to the banks' attractive revenue pool, such as FX, payments and insurance.

Participants in the market with large customer bases and brand trust are the ones likely to benefit from open data, the broker adds. While this may also offer opportunities for incumbents to leverage investment in technology and customer reach, open data is currently viewed more as a compliance exercise.

As technology is increasingly important, scale benefits become even more critical and Macquarie believes smaller banks will find it increasingly hard to compete. Credit availability may have improved from a trough earlier in the year but, overall, borrowing capacity remains lower versus 2018.

Responsible lending rules are expected to be finalised later this year by the Australian Securities and Investments Commission, which should provide clarity on expense assessment. However, if ASIC leaves scope for interpretation, the gap in credit assessment is likely to remain, and this disadvantages the major banks. Macquarie considers the market share losses are partially attributed to pricing and partially to the credit assessment process of the major banks.

Ultimately, the regulator is expected to require banks to include transaction data verification as part of their assessment process and this will increase the cost of assessment across the industry.

The retailing industry is being challenged by stretched household balance sheets, low wages growth, new entrants and cost inflation. Yet despite some stress being shown in the retail portfolios of the banks, the loss rates remain close to cyclical lows.

Conditions could deteriorate, JPMorgan suspects, although tax breaks, rate cuts and a bottoming of the housing market should provide some relief. Regardless, the broker estimates Australian retail exposures comprised around just 1% of total bank exposures so the impact appears manageable.

Consumers

UBS assesses consumer perception of household finances will be the key determinant of expenditure. From the survey of 1200 Australian consumers, conducted before the federal election, around 8% were positive about the outlook for household finances for the next 12 months. The results were weakest in Queensland and Victoria.

While consumers were more negative regarding the outlook for wealth, which UBS believes reflects weaker house prices, some positive effect is expected since the Reserve Bank reduced official rates in June and July. Consumers were, largely, optimistic, expecting incomes and expenditure to grow.

Respondents also expect to travel more in the next year, which the broker considers is a positive for Flight Centre ((FLT)), Webjet ((WEB)) and Qantas ((QAN)). However if the Australian dollar falls -10%, around 35% of respondents will travel less or not at all.

Increased expenditure on hardware and online shopping is also likely to benefit Wesfarmers ((WES)). Despite higher electricity prices, less than one fifth said they will consider switching suppliers in the next year, which UBS believes is a positive for AGL Energy ((AGL)) and Origin Energy ((ORG)).

While falling expenditure on electronics and apparel was expected, respondents have also said they would cut back on services and dining at shopping centres. This is seen as a negative for Scentre Group ((SCG)) and Vicinity Centres ((VCX)) and a positive convenience-based centres such as Charter Hall Retail ((CQR)) and SCA Property ((SCP)).

Growth in food aggregators points to downside risks for Domino's Pizza ((DMP)) market share. The survey also highlighted an opportunity for Viva Energy ((VEA)), where there is potential to re-gain share in fuel via improved prices, but a greater challenge in non-fuel business for Caltex ((CTX)).

In online business, results of the survey were positive for incumbent retailers with local websites being the best positioned in the next 12 months. Furthermore, online penetration growth in electronics is growing more slowly than expected, which is a marginal positive for JB Hi-Fi ((JBH)) and Harvey Norman ((HVN)), UBS suggests.

Respondents were asked which online portal websites they use. While recognising the survey was narrow and did not capture important metrics such as engagement and time on site, UBS has confirmed the dominance of REA Group ((REA)), Seek ((SEK)) and Carsales.com ((CAR)) in their respective verticals.

While the survey showed REA Group held a national lead over Domain Holdings ((DHG)), its dominance stems from geographies outside NSW. Hence, if Domain can use the Nine Entertainment ((NEC)) network to grow share in other markets, the revenue opportunity could be substantial.

Housing Construction

Australia's unprecedented housing boom was dominated by apartments and this segment is now leading the decline. Morgan Stanley observes this segment is also less materials-intensive.

While the declines in detached housing are more modest, the broker's analysis shows that there is still significant weakness ahead for building materials providers. The worst of the downturn is expected to hit in FY20, while forecasts indicate activity will not trough until late FY21.

Residential-exposed building materials stocks enjoyed a post-election bounce which the broker suspects came too early. An Underweight rating is reiterated for CSR ((CSR)), which has the greatest residential exposure.

The broker continues to favour those stocks with exposure to Australian infrastructure construction and/or offshore earnings such as James Hardie ((JHX)), Boral ((BLD)) and Reliance Worldwide ((RWC)).

Megaport Storming Ahead

Brokers are increasingly confident network services provider Megaport has a bright future after the June quarter revealed significant growth in revenue and installed locations.

-Significant revenue potential on view over the longer term -Analysis on services and ports encouraging -On current trajectory positive operating earnings may occur in FY22

By Eva Brocklehurst

Revenue is growing at a fast clip for network services provider Megaport ((MP1)) and brokers are confident the business has a profitable future. Of significance is the 300 physical data centre target, which the company reached recently, after adding 36 data centres in the June quarter.

Quarterly revenue was $10.9m, up 22%. Customer numbers increased by 9% and services by 11%. Revenue per data centre increased by 33%, an important metric, Canaccord Genuity suggests, because Megaport incurs fixed costs around leasing lines between data centres.

UBS asserts the compounding effect of stronger quarterly growth may have a material impact on the revenue potential over the longer term. The broker was hoping for more acceleration in the number of ports being added, given the investment in the sales force, although retains a belief there is ample upside potential.

While recognising that a lot of the current growth trajectory is priced in current levels, UBS still envisages value and maintains a Buy rating. The broker's target is raised to $8.65 from $6.25. Morgans also increases its target substantially, to $8.80 from $5.12, largely because forecasts now include four services per port, which is equivalent to 11 services per customer, according to the company's cohort analysis.

Canaccord Genuity is encouraged by the fact that despite adding new customers at a healthy rate, the number of ports per customer has remained relatively steady. This is because it would be reasonable to expect new customers to take a measured approach to the uptake of ports and other services, thereby potentially diluting the average.

Strong Outlook

UBS remains comfortable with the structural shift to the cloud that is supported by continued growth in Microsoft Azure and Amazon Web Services. The broker has surveyed 500 IT management executives, which revealed continued uptake of the cloud by new users, with 40-45% of respondents planning to use multiple cloud products. The company can achieve triple leverage at the revenue line, UBS adds, underpinning a forecast for a revenue compound growth rate of 47%.

Morgans assesses the increase in sales staff has been a good investment as record sales were added in the June quarter. The broker acknowledges Megaport needs to continue adding data centres and customers to fuel long-term growth but, in the medium term, the trajectory is driven more by existing customers taking more services.

This is an important metric, Morgans points out, as not only does it drive higher profitability but proves the company is adding significant value to the end consumer. The main risk to the share price, in the broker's opinion, relates to interest-rate increases, currently considered unlikely. Low rates are driving valuations on growth stocks although this could change over time.

Canaccord Genuity is also impressed with the operating metrics. The business exits FY19 with $3.6m in monthly recurring revenue, representing $43m in annual revenue. The broker accepts it may be overly ambitious to be stating that a business that is losing -$25m at the operating earnings (EBITDA) level in FY19 could have clarity regarding a turn to profitability.

However, Canaccord Genuity is confident the final results will show that revenue is growing at a must faster rate than costs. On the current trajectory, the broker expects the business to be positive in terms of operating earnings in FY22, increasing the target to $7 from $4 and maintaining a Hold rating.

Senex Outlook Fuels Re-Rating Hopes

FY21 will be a watershed year for Senex Energy and several brokers expect the stock to re-rate as gas production increases and LNG spot prices recover.

-Attractive outlook for Queensland gas projects but risks still exist -10 wells to be drilled at Roma North and brought online in current quarter -Senex Energy likely to get preferential access to acreage

By Eva Brocklehurst

Senex Energy ((SXY)) has attractive characteristics for many brokers, being on the cusp of ramping up its energy portfolio. The company has an integrated plan for its Queensland gas projects, expecting to complete the entire drilling campaign by mid 2020.

Commissioning of Roma North is near completion and the asset is now selling sales gas to the GLNG joint venture. At Project Atlas, drilling will commence next month with further sales gas expected by the end of the year. These two projects are expected to add around 48 TJ/day to Australia's east coast markets by the end of FY21. Moreover, Macquarie expects the stock to re-rate as first gas flows are announced from Project Atlas.

Senex Energy executed three agreements at Project Atlas in the June quarter. Up to 24PJ of gas will be sold to domestic manufacturers from FY20-28. Credit Suisse would like to witness shorter-duration contracts, so the company can gain further upside exposure as LNG spot prices recover from 2021.

Yet, the broker envisages material upside once Roma North and Project Atlas are at plateau production rates, likely at the end of FY21. Ord Minnett, too, is cautious about the quality of some of the assets.

Production fell from a recent peak in the March quarter to 1.2mmboe in the June quarter, as natural field decline and maintenance in the Cooper Basin was partially offset by growth in Surat Basin gas. Revenue was softer because of a higher proportion of gas sales.

Ord Minnett reduces earnings estimates to account for a lower oil production outlook. Senex Energy reported net production of 308,000 barells of oil equivalent for the quarter, -8% below the March quarter and -21% below the broker's forecasts.

The company expects to complete the facility sale at Roma North in September, adding further $50m in liquidity. Additional cash will come from the Cooper Basin and the ramp up of current projects. Hence, Bell Potter suggests the company is well funded for future developments. The broker, not one of the seven monitored daily on the FNArena database, has a Buy rating and $0.47 target.

Canaccord Genuity, also not one of the seven, retains the view that the company has more than enough financial flexibility to manage its current investment plans and has a Buy rating and $0.53 target. The broker was buoyed by the decision by Jemena to acquire the Roma North gas processing plant, considering the acquisition another external validation for this project.

Risks

Credit Suisse downgrades to Neutral from Outperform, as the share price has recovered, after a drop that caused the upgrade on pure valuation terms previously. Also, risks in the near term could dampen sentiment, the broker assesses, and counter any upside.

There are risks with Roma North, despite the progress being made. Credit Suisse does not believe the ramp up is "amazing", given the 35 wells drilled to date, and would like to dissect more details on well workover frequency and costs, which could materially affect the valuation.

While noting a total of 10 wells are expected to be drilled at Roma North and brought online during the first quarter of FY20, Ord Minnett, too, is cautious, specifically regarding the quality of some of the Queensland assets.

Attractions

The company's appeal in Credit Suisse's view, lies in its uncontracted gas supply position which could likely to benefit from higher gas prices, while new acreage is unlikely to be a near-term catalyst, hence no value is attributed to Artemis in the near future.

The company was awarded the Artemis block at a recent tender. Canaccord Genuity notes initial exploration is likely to focus on the north-east corner where there is 30-40PJ potential. Upside is expected to come from the higher risk and more technically challenging south-east.

The company's position as a local motivated explorer should enable preferential access to acreage, another attractive characteristic Credit Suisse assesses. Morgans views the company's operations in CSG comparable to a mining concern, where development capital expenditure is sunk and construction completed before earnings growth becomes substantial.

A typical CSG well takes, on average, 12-18 months to de-water before the majority of gas is liberated. Hence, Morgans also expects FY21 will be an important year for the business and earnings growth should reach a point where the company is trading on just 5.0x enterprise value/EBITDAX (operating earnings before exploration expenses).

The market appears unwilling to look that far ahead, so Morgans believes now is a good time to accumulate the stock before the attractive earnings profile comes into focus. Senex Energy has two Buy and four Hold ratings on FNArena's database. The consensus target is $0.433, signalling 20.4% upside to the last share price. Targets range from $0.36 (Ord Minnett) to $0.55 (Macquarie).

Plenty Of Positives For Orocobre

High lithium inventory, trade and political tensions have impacted Orocobre in the June quarter. Nevertheless, brokers believe the business is well-positioned for when the market turns around.

-Cash flow is benefiting from full sales of production, unlike hard-rock peers -Focus on improving product quality and range -No change in current prices considered imminent

By Eva Brocklehurst

A depressed lithium price may be compressing margins for Orocobre ((ORE)) but brokers find plenty of positive aspects to the company's outlook. There is a strong balance sheet to fund growth plans and the business is positioned for when the lithium market is more buoyant.

The company acknowledges the market is soft, affected by both industry and macro dynamics. Inventory is high at the customer end and trade and political tensions globally are affecting investor decisions.

Cash costs of US$4493/t were higher than expected in the June quarter, primarily because of local cost inflation and batch production of higher-cost purified product. Sales volumes are projected to match production, nevertheless, supported by 70% being under contract. Sales of 3400t were at US$8220/t, a -13% drop in pricing quarter on quarter. Cash costs were higher, reflecting increased purified production.

Despite a drop in prices and higher costs the company still managed to produce a gross cash margin of 45%. This is a favourable outcome versus peers, Credit Suisse points out, as around 98% of production was sold, in contrast to spodumene producers that are struggling to clear around 50%.

Cash flow is benefiting from the full sale of production, unlike hard-rock peers. Furthermore, it is a reminder, Canaccord Genuity asserts, of the low position on the cost curve of Olaroz and the options for any recovery in lithium pricing.

Production

The company intends to provide FY20 guidance for production in conjunction with its August results. Orocobre has not provided guidance since the first quarter of FY18. Canaccord Genuity, not one of the seven brokers monitored daily on the FNArena database, considers this a reflection of increased confidence in the additional ponds ahead of stage 2 expansion and retains a Buy rating and $6.50 target.

Yet there are still risks to the sustainability of Olaroz stage 1 nameplate production amid construction/commissioning risk for stage 2, Morgan Stanley asserts. On the other hand, Baillieu expects improvements in the stability of operations as expenditure on stage 2 ponds will add to the resilience of stage 1 operations.

The company plans to improve plant availability and reduce unplanned maintenance amid a potential reduction in soda ash consumption, hopefully leading to lower costs in the September quarter. Still, Baillieu, not one of the seven, considers the share price is more likely to reflect the lithium carbonate price rather than improvements in operating performance. The broker has a Hold rating and $3.01 target.

Morgans points out production from Olaroz is seasonal, affected by rainfall, snow and evaporation rates. Higher lithium grades and harvest ponds are conducive to increased battery grade product. Hence, Orocobre is focused on improving product quality and range and also bettering margins.

The company has advanced stage 2 works at Olaroz, having spent US$40m of its US$295m budget. While a formal review is ongoing, Orocobre has indicated there are no surprises, which suggests to Credit Suisse there is limited risk of any design change or expenditure blow-out. The commissioning timetable for Naraha is unchanged, slated for the first half of 2021.

Pricing

The main issue for brokers is about how the company's realised lithium carbonate pricing is playing out amid weakness in the Chinese price, and the potential impact from the intended increase in purified product.

While management believes all production can be sold, Baillieu notes negotiations with customers over schedules continue. The company does not find any change in price from current levels is imminent. Credit Suisse, on the other hand, envisages downside risk, as the market is likely to be in oversupply before the balance improves.

Considering subdued electric vehicle sales in China and the transition to the new subsidy environment the broker reduces forecasts for lithium carbonate and projects a 2020 battery grade price of US$9750/t, versus US$12,000/t, bringing forward the timing of price declines.

Citi also observes no imminent turnaround in lithium pricing. Inventory remains high at the customer end, reflecting weak demand for lithium product at an industry level. The broker notes a transition period for Chinese new electric vehicles subsidies concluded at the end of June and this is likely to keep the lithium market subdued at least for the second half of 2019.

Citi believes Orocobre offers leverage to volume growth and a better product mix, and the benefits from its two projects should be visible from 2021 onwards, supporting earnings despite the weak macro backdrop.

Credit Suisse, too, continues to like the stock for its quality, scalability and cost advantages and the benefits a successful execution on stage 2 should deliver. There are also other growth options including hydroxide, Cauchari and stage 3 at Olaroz.

FNArena's database has five Buy ratings and two Hold. The consensus target is $4.13, signalling 44.4% upside to the last share price targets range from $3.25 (Morgan Stanley) to $5.05 (Morgans).

SMSFundamentals: Australians' Net Wealth Nearly Double Since Before The GFC

SMSFundamentals is an ongoing feature series dedicated to providing SMSF trustees with valuable news, investment ideas and services, in line with SMSF requirements and obligations.

For an introduction and story archive please visit FNArena's SMSFundamentals website.

Australians' Net Wealth Nearly Double Since Before The GFC

National net wealth nearly doubles in 12 years Even after inflation, the average Australian is 28% richer Home ownership and superannuation are key stores of wealth Inequality has widened, with the rich growing their wealth faster than the poor By Nicki Bourlioufas

Australians' total net wealth has nearly doubled since just before the global financial crisis, with home ownership and superannuation being the key ways that individuals have increased their wealth.

However, inequality has widened as the rich grow their assets much faster than the poor, reflected in median net wealth per capita of just $134,900 in 2019.

The new Roy Morgan Wealth Report, now in its second edition, shows that the total value of assets in the hands of individual Australians has grown by 96% since 2007, while total debt has grown by only 78.6%.

As a result, national net wealth is now 98.7% higher now than it was in 2007. This highlights how well Australia as a whole has fared since the crash, particularly compared to some European countries.

Michelle Levine, chief executive officer of Roy Morgan, said the figures show "a very positive long term trend" that provides some balance to "the daily headlines about risks posed by high levels of debt and falling property values".

Assets have grown faster than debt

The average figures paint an encouraging picture. In 2007, Australians' average assets per head were $298,000 while average debt per head was $40,500, so average assets were worth 7.4 times average debt.

In the past 12 years, average assets per capita has grown to a $484,000 while debt has grown more slowly to $60,000, so average assets are now worth 8.1 times average debt.

This means net wealth per head has grown by 65.1% over the 12-year period, or 28% in real terms, after adjusting for inflation.

Home ownership and superannuation are the key stores of wealth

About half of Australia's personal wealth is still held in the form of owner-occupied housing, which accounts for 49.8% of the total in 2019, down slightly from 51.6% in 2007. Meanwhile, the proportion of wealth held in superannuation has jumped to 24.4% from 19.2%.

The effects of the housing boom show up in the differences between the states, with both NSW and Victoria well ahead of the others in terms of both housing values and growth rates. NSW has the highest average net wealth with $503,000, up 91% since 2007, while Victoria is second with $465,000, up 89%.

Ms Levine said housing debt has grown considerably since 2007, but Roy Morgan's data show "wealthier cohorts have shown a much greater propensity to take on debt and those investors have more ability to handle downturns than more marginal borrowers in lower-wealth segments".

Not surprisingly, time is a major factor in building wealth. People aged 65 and over have the highest average net wealth of $759,000, up 95% since 2007. This puts them well ahead of the 25-34 age group, who are just starting their wealth-building journey with an average of $111,000, up 6%.

The good news is that women have improved their average net wealth position compared to men. In 2019, men hold 12.3% more wealth than women, while back in 2007 they held 27.4% more.

Inequality rises as the rich get richer and the poor struggle with chronic debt

A more challenging picture emerges when the analysis focuses on the median figure rather than the average. The median shows the net wealth of people who are at the midpoint of the population, with half of all Australians sitting above their level and half below.

The median net wealth of that “middle Australian” is just $134,900 in 2019 compared with $124,000 in 2007, a rise of 8.8% after inflation. According to Roy Morgan, the median value is a more representative metric “in such a highly skewed market” where just a few people hold the bulk of the nation’s wealth.

Reflecting the widening gap between the rich and the poor, in 2019, the top 10% of the population hold net wealth of $2.034m, up 66% from $1.233m in 2007. That represents nearly 48% of total net wealth, while the 50% of Australians who sit below the halfway mark hold only 3.7% of the total.

The new Roy Morgan Wealth Report covers the period from 2007 to 2019. The data and analysis are drawn from more than half a million in-depth face-to-face interviews conducted in Australians’ homes over the 12-year period.

Wellbeing is higher too

According to a separate report, Australian wellbeing sits at a six-year high. NAB’s Wellbeing Index increased 0.5 points over the second quarter of 2019 to a six-year high of 65.7 and tracked above average (64.5). The NAB Australian Wellbeing Index is derived from questions relating to how people think and feel about their lives in regards to their life satisfaction, life worth, happiness and anxiety.

We were also noticeably less anxious. NAB’s Financial Anxiety Index, based on concern over future spending and savings plans arising from our current financial position, moderated to 56.3 points and likely played a key role supporting lower overall anxiety.

The key drivers underpinning our financial anxiety continue to reflect our fear of not having enough to finance our retirement, being unable to provide for our family’s future and not being able to meet medical costs.

Credit card debt is still the most commonly held debt by almost one in two Australians, followed by home loans (30%), personal loans (19%), loans from family or friends (15%), investment loans (8%) and payday loans (7%).

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

Corporate Earnings Still Matter In 2019

Dear time-poor reader: this week I explain why global equity markets have been paying scant attention to corporate earnings, which doesn't mean August will be a complete waste of time.

Part Two (on Friday) contains an interesting piece of research on Australian banks, and further zooms in on the threats and risks from super-accommodative central bank policies and the ever rising mountain of global debt; and why there still is no inflation danger.

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

-Corporate Earnings Still Matter In 2019 -Dividends, Quality And Australian Banks -Central Banks' Policies Not Without Risks -Charts: Mind The Output Gap, And Global Debt -Rudi Talks -Rudi On Tour -Rudi Talks

Corporate Earnings Still Matter In 2019

By Rudi Filapek-Vandyck, Editor FNArena

In the share market all that matters are corporate profits and growth, or so the mantra goes.

But sometimes the direction for the share market is guided by a number of other catalysts, relegating corporate earnings to merely a secondary role. See the past twelve months as Exhibit A in support of that statement.

In August last year, investors were fretting about high valuations for Quality and Growth stocks, while bruised value-oriented funds managers were speculating whether their moment under the sun was -finally- about to arrive.

The 2018 August reporting season did not provide any clues about a profound and sustainable switch in market dynamics. If anything, stocks like CSL ((CSL)) and REA Group ((REA)) surged to new highs upon release of financial performances.

Once the reporting season was finished, investors' hope soon turned into despair as markets started a relentless downtrend for the final four months of the calendar year. That downtrend turned into a savage sell-off as year-end approached. Then Christmas came and put general anxiety on pause.

Next the Federal Reserve reversed its policy outlook -there would be no more tightening via Fed Funds Rate increases- and financial markets have rallied circa 20% over the following seven months.

In between, consensus forecasts for corporate profits have continued to fall, with one notable exception: iron ore miners. The Australian economy too is notably weaker than one year ago, now also pulling the RBA into stimulus action through two rate cuts this year, and ongoing promise of more to follow.

Bond yields the world around are significantly lower. US Treasuries are still flirting with an inverted yield curve whereby longer duration government debt carries a lower yield than short duration debt. In Australia, this year's August reporting season has been preceded by what seemed an unusually crowded period of profit warnings throughout April, May and June.

On some estimates no less than 250 ASX-listed entities have warned their shareholders they will not be able to meet prior guidance or promises.

And yet, the ASX200 is trading within a one day's rally of the late 2007 all-time high. In the absence of improving profit prospects (outside of iron ore), share market valuations have risen instead and are now back to multiples that bring back memories of late 2007. At least for those stocks and sectors that have fully participated in the 2019 bull market rally.

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If, after reading the above paragraphs, you might feel inclined to conclude that corporate profit growth hasn't really mattered post August last year you are partially correct.

Companies with the ability to power along, continuing to deliver where it matters most, have seen their share price enthusiastically rewarded. Those that had to acknowledge it couldn't be done, or that disappointed otherwise have been punished severely. Achieving a return in the footsteps of the share market's +20% advance has been a case of owning winners, but equally of avoiding the losers.

Yet, this is still only part of this year's share market story.

In contrast to prior global economic downturns post GFC, this time the Australian economy has been noticeably weak too. In addition, long-term mega-trends such as the emergence of online competition and changing consumption patterns still apply. Which is yet another reason why whole sectors and segments of the Australian share market have failed to keep pace with the broader market's upswing.

Some laggards are starting to attract attention, but only because investors are speculating that two RBA rate cuts, and more likely to follow, might stabilise housing markets, which then should translate in better conditions for builders and building materials companies, and in more spending by debt-constrained households.

The average profit growth forecast ex-iron ore sits in between zero and 1% ahead of the August reporting season, and is still falling as preparations are being made for the mid-year onslaught of corporate updates. Low expectations usually feed into investor confidence that not much is required to do a smidgen better. But it is still undeniably tough out there. 250 profit warnings are not a pretty-looking warm up.

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August 2019 could well turn into a multi-level reporting season experience.

On one hand we have high quality, high achievers on elevated multiples. On the other side of the spectrum there are large swathes of the market that have been largely ignored and forgotten about up to this point. Clearly, there are problems that need to be dealt with, and preferably in a convincing and sustainable manner.

In between are the companies that haven't delivered yet, and they are unlikely to do so in August as it remains early days to see much crystallising in terms of improved building activity or increased consumer spending. My suspicion is these companies will continue to enjoy the benefit of the future promise; as long as the financial result in August doesn't shatter any reasonable prospects.

A Big Question Mark will remain for those on the wrong side of the world's tectonic shifts and regulatory scrutiny, including retail landlords, aged care centres and accommodation for seniors, and value investing-style asset managers. It's most likely equally way too early as yet to see any evidence of a turn in the cycle for new battery materials, or thermal coal, or travel and tourism enterprises.

Can some in the business nevertheless convince investors their efforts deserves a higher share price?

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As has become the new norm, both locally and internationally, in the absence of solid growth numbers and market-beating guidance, a lot of attention will go out towards higher dividends, special pay-outs and share buy backs. Again, the sole market segment that continues to enjoy better-than-anticipated market dynamics -the iron ore producers- will be front and centre of investors' expectations for a little extra on top of robust looking growth numbers.

Dismal profit growth does not mean there cannot be further growth in dividends, as companies can decide to pay out extra to prove their confidence or to reward shareholders after a challenging period. Ultimately, of course, savvy investors will be weighing up whether any of it is sustainable, and whether it is worth staying on the register regardless.

Here it is worth mentioning international research has identified companies buying back their own shares as most likely to outperform. A recent report by JP Morgan put the average outperformance vis-a-vis the broader market index at 4%-plus per annum in both Europe and the US.

While it is true that shareholders in the likes of BHP Group ((BHP)) and CSL have been well-rewarded on the back of buy backs in the past, it is also my observation that not all share buy backs have the same positive impact. What I would refer to as a "defensive buyback", when the board announces a buy back amidst lots of challenges and bad news, often helps with stabilising the share price, but it fails to also generate outperformance.

In the absence of much in terms of actual growth in profits, it is likely capital management will once again become one of the defining features of the upcoming reporting season. Also because challenged business models are being restructured and streamlined through divestments of non-core assets (Graincorp ((GNC)), Woolworths ((WOW)), EclipX Group ((ECX)), etc).

Prime candidates for delivering capital management in August include BHP Group, Rio Tinto ((RIO)), Origin Energy ((ORG)), and Aurizon Holdings ((AZJ)).

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Lastly, but certainly not least, expectations for FY19 might be low, and most companies might be able to meet or even beat them in August, most experts locally are convinced market expectations for 8% growth in earnings per share on average for FY20 seem way too optimistic.

This happens in most years in Australia. Once FY19 is behind us, and analysts start looking towards FY20 in more detail, also with the latest input included, forecasts tend to trend downwards. See this year's trend as Exhibit B.

For investors the Big Question is whether such downgrades need to happen as soon as August, alongside company guidance for the year ahead, or whether this remains a gradual process that mostly affects other companies not held in the portfolio.

Analysts will be looking more closely in the weeks ahead whether they can find any candidates that appear most likely to disappoint, either on actual performance numbers or through management's guidance. Getting this right is notoriously difficult, but investors might want to take on board that "surprising to the upside" or "disappointing" during reporting season can lead to outperformance and underperformance respectively of up to three months (and sometimes longer) after the results release.

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As happens prior to every reporting season, investors are nervous about whether highly valued share prices might be due a correction once the financial results have been released. This is quite normal and on my observation nothing but a twice annually recurring ritual.

Within this context, one observation from the February reporting season is worth highlighting. In February, for no obvious reason or common denominator, a number of the Quality, Highly Valued names on the Australian stock exchange could not enthuse investors and their performances, seen as "disappointing", were met with investors selling out, putting share prices under pressure.

Think CSL, REA Group, ResMed ((RMD)), Carsales ((CAR)), among numerous others. Look up any of these price charts and one can clearly see the "correction" that occurred in February (late January for ResMed) but here we are, five months further and all those share prices have regained the losses, paid out dividends, and rallied to new highs.

Herein might lay the opportunity for those who as yet have not jumped on board any of these long term, structural, Australian success stories.

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Most teams of analysts and market strategists are yet to release their previews and recommendations ahead of August.

Macquarie analysts suggest buying Fortescue Metals ((FMG)), Charter Hall ((CHC)) and WorleyParsons ((WOR)) into their respective results releases still makes sense. Macquarie sees all three as major candidates to beat market consensus. a2 Milk ((A2M)) is also seen as a prime candidate for upside surprise.

On the other hand, South32 ((S32)), CommBank ((CBA)) and Cochlear ((COH)) are considered prime candidates for disappointment.

Analysts at Morgans are habitually concerned stocks trading on elevated price-earnings (PE) multiples are at risk for disappointment and subsequent capital punishment. Stocks with the potential to beat expectations include, according to Morgans, a2 Milk, AP Eagers ((APE)), Medibank Private ((MPL)), Megaport ((MP1)), Australian Finance Group ((AFG)), as well as IPH ltd ((IPH)).

Companies with ongoing "solid fundamentals" include Treasury Wine Estates ((TWE)), Cleanaway Waste Management ((CWY)), Telstra ((TLS)) and Monash IVF Group ((MVF)).

Stocks best avoided, according to the stockbroker, due to risk of reporting season disappointment, include Nanosonics ((NAN)), Bellamy's ((BAL)), NextDC ((NXT)), Carsales, Flight Centre ((FLT)), Coca-Cola Amatil ((CCL)), CSL, REA Group, AGL Energy ((AGL)) and Woodside Petroleum ((WPL)).

Apparently, the onus is also to the downside for Netwealth ((NWL)) and Hub24 ((HUB)), Suncorp ((SUN)), Ansell ((ANN)), Webjet ((WEB)), Computershare ((CPU)), and Spark Infrastructure ((SKI)).

As has now become tradition, FNArena will keep a daily eye on corporate releases and the respective responses from stockbroking analysts via the dedicated Corporate Results Monitor on the website. See drop down menu starting from Analysis & Data.

See also "Dividends, Quality And Australian Banks" in Part Two of this week's Weekly Insights.

Next week I shall be attending the National Conference of the Australian Investors Association (AIA) on the Gold Coast. Weekly Insights shall resume with ongoing focus on the local reporting season from the following week onwards.

Rudi Talks

Audio interview from Wednesday last week:

https://www.youtube.com/watch?v=BTmBz-IC8JA

Rudi On Tour In 2019

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

In 2020:

-ASA Hunter Region, near Newcastle, May 25

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

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

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Rudi's View: Banks, Central Banks, Inflation & Debt

Dear time-poor reader: Part Two contains an interesting piece of research on Australian banks, and further zooms in on the threats and risks from super-accommodative central banks' policies and the ever rising mountain of global debt; and why there still is no inflation danger.

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By Rudi Filapek-Vandyck, Editor FNArena

Dividends, Quality And Australian Banks

With the August reporting season approaching fast, I thought it worthwhile to reference one particular piece of research released last year by banking analysts Brian Johnson, Christopher Kightley and Ed Henning at CLSA.

The three conducted detailed historical share price performance data and found there is quite the difference as to how long it takes for the Major Banks in Australia to see their share prices recover after having paid out dividends to shareholders.

For some among you, no doubt, this will be useful information when setting up specific, timing-based dividend stripping strategies. For others, it is yet another piece of evidence that corporate quality does show up, as long as investors are looking into the right direction.

As it turns out, CommBank ((CBA)) shares tend to require significantly less time to recoup the loss in dividend. CLSA's research stretched back 53 dividend payments up until August last year and their calculation is that CommBank shares require about 44 days on average to fully compensate for going ex-dividend following the release of interim and full year corporate profit results.

The difference? Westpac ((WBC)) shares require an average of 87 days. For ANZ Bank ((ANZ)) shares the average duration is 91 days and National Australia Bank ((NAB)) needs 92 days. The research did not include any of the regionals, but my gut feel tells me they won't do this quicker than CommBank or even Westpac.

Also, the gap between CommBank shares and the first runner up -Westpac- is nearly double in time. This makes one wonder: why such a big difference?

One explanation could be that CommBank shares virtually always trade at a premium versus the rest of the pack, and this means less needs to be compensated for, in terms of percentage loss from going ex-dividend. This would also explain why Westpac comes second, and why NAB sits at its familiar sector-last position.

But the gap between CommBank and the others is way too large to simply blame the market leader's valuation premium. CLSA saw a correlation with the tighter-than-peer share register for CommBank. Shareholders consist mostly of retail investors, and they don't necessarily sell upon receiving dividends, suggest the analysts.

In other words: it's the institutional investors that are to blame. They are structurally underweight the sector leader. I would wager this might also be the case because analysts tend to feel attracted to the "cheaper" alternatives, which, as my own data research taught me over the many years past, does not translate into the better investment returns.

The irony of the local banking sector is that, over time, CommBank shares significantly outperform the three other Majors, and this runs contrary to the general belief that "valuation" and a "cheaper entry point" are sacrosanct for achieving superior long term returns.

National Australia Bank shares have looked the "cheapest" ever since the in-house currency scandal from around 18 years ago. The shares pay out the highest yield. NAB shares are most often recommended as a Buy/Outperform for these reasons.

But apart from a temporary catch-up rally here and there, NAB shares have proved the perennial underperformer in the sector and CLSA's research into the duration of loss of dividend compensation in banking share prices again confirmed the NAB as the least desirable exposure to the sector.

Viewed from another angle: CommBank is, simply put, the best in the sector locally. Apart from carrying a permanent valuation premium vis-a-vis its peers, the CLSA research provided yet another piece of evidence that quality does matter for long term, buy-and-hold investors.

Below is more evidence from my own personal research, which has been part of my PowerPoint presentation slides for a number of years now. Simply observe the differences in share price returns.

Central Banks' Policies Not Without Risks

Thus far, the story about ultra-accommodative central bank policies post-GFC is coloured with right wing political populism, sharply increased inequality and asset price inflation. Most retirees and investors would consider this a positive outcome, on balance, as do governments who are notably absent, and have been for quite a while now.

But nothing is without consequences and the fact that flooding the globe with excess liquidity hasn't yet shown up in a tangible negative outcome might just be a matter of time and/or timing.

Mohamed El-Erian, chief economic advisor at Allianz and author, most recently, of The Only Game In Town: Central Banks, Instability and Avoiding the Next Collapse, suggests investors should not let themselves being lulled into some kind of complacency, simply because thus far the outcome appears to be without too much of negative consequences.

In a recent Op-Ed, El-Erian writes that, "In recent years, central banks have made a large policy wager. They bet that the protracted use of unconventional and experimental measures would provide an effective bridge to more comprehensive measures that would generate high inclusive growth and minimise the risk of financial instability.

"But central banks have repeatedly had to double down, in the process becoming increasingly aware of the growing risks to their credibility, effectiveness and political autonomy."

That Op-Ed, by the way, concludes with the following sentence: "Like seasoned gamblers, central bankers may soon discover that not all bets pay off over the longer term."

According to some market analysts, central bank policies have transformed the global economic and financial system into a rather binary matter of liquidity: is there enough/plenty liquidity sloshing around inside the system, or not?

Investors looking for a thorough understanding of what this type of financial conundrum implies for equities and other assets, and for central banks' options and considerations moving forward, need not look any further than the interview of Michael Howell below. Howell was once upon a time head of research at Barings in the UK and one of the first to incorporate the concept of liquidity in his market research.

The interview below is both revealing and frightening, and a must see for every investor who likes to stay on top of how exactly today's world is morphing into something different than the world we all know from decades past:

https://youtu.be/Loj0z43VZ7I

Another market expert whose views have generated quite the attention recently is Ray Dalio, founder of Bridgewater Associates, one of the world's largest hedge funds. His updates require reading:

https://www.linkedin.com/pulse/paradigm-shifts-ray-dalio/

Charts: Mind The Output Gap, And Global Debt

One does hear the mantra still, every so now and then, what if the world is confronted with inflation breaking out to the upside?

While it is true that nothing ever lasts forever, it is but an accurate observation that inflation has largely gone missing in years past and most experts that had been advising their clientele to hedge and/or prepare for the return of inflation have gone eerily silent, having been proven awfully wrong by the facts.

Central banks' policies are seen as co-responsible by some. Others seek an explanation in demographic changes and the advent of new technologies as well as the significant broadening of the available labour pool for jobs and tasks in developed economies through the inclusion of citizens in Emerging Markets.

Does the largest mountain of debt in human history by default keep a lid on price inflation, or is it merely a case of too much debt weighing upon household budgets?

My personal interest was piqued last week when David Rosenberg, chief economist and strategist at Canada's Glushkin Sheff, published the graphic below, revealing the output gap for OECD countries has simply never fully closed post-GFC, and it doesn't appear this gap is about to close soon either.

Economics 101 suggests that unless this gap is closed, implying the world's largest economies are starting to operate at full capacity, and then moves further away from the zero line on the upside, the global economy is likely to remain captured by deflationary forces, which is the exact opposite of runaway inflation.

Looking at the chart above, and considering economies are weakening which means the gap is widening again, this strongly suggests -all else remaining equal- it remains far, far, far too early to worry about inflation.

At the same time, and this is quickly turning into one of the dominant characteristics of the modern era, global debt is growing at much quicker pace than global growth, see Rosenberg's second chart below. This, for obvious reasons, raises a few questions about longevity and sustainability or do Modern Monetary Theorists have a point?

For those readers who'd like to get acquainted with what this is all about, FNArena published an introductory explanation on Modern Monetary Theory, or MMT as it is colloquially referred to nowadays, in May.

https://www.fnarena.com/index.php/2019/05/15/modern-monetary-theory-global-saviour-or-highway-to-hell/

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-ASA Hunter Region, near Newcastle, May 25

(This story was written on Monday and Tuesday 22nd & 23rd July 2019. It was published on the day in the form of an email to paying subscribers, and again on Thursday as a story on the website. Part two follows on Friday).

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