WEEK 12

FINANCIAL NEWS, ANALYSIS & DATA

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Friday, 19 March 2021

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Rudi's View: Are Australian Banks Back As An Indicator?

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FNArena
Financial News, Data & Analysis

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AUSTRALIA

Have Bonds Moved Too Fast, Too Far?

While bonds yields have risen on higher inflationary expectations, driven by higher commodity prices and expectations surrounding large US fiscal stimulus, the big unknown is what will happen next?

-Australian bonds suffered biggest negative monthly return since 1983
-Headline ASX performance masks discrepancy between sectors
-Mayhem experienced in rates market could extend into risk assets
-Allocation to inflation-linked bonds will help protect portfolios

By Mark Story

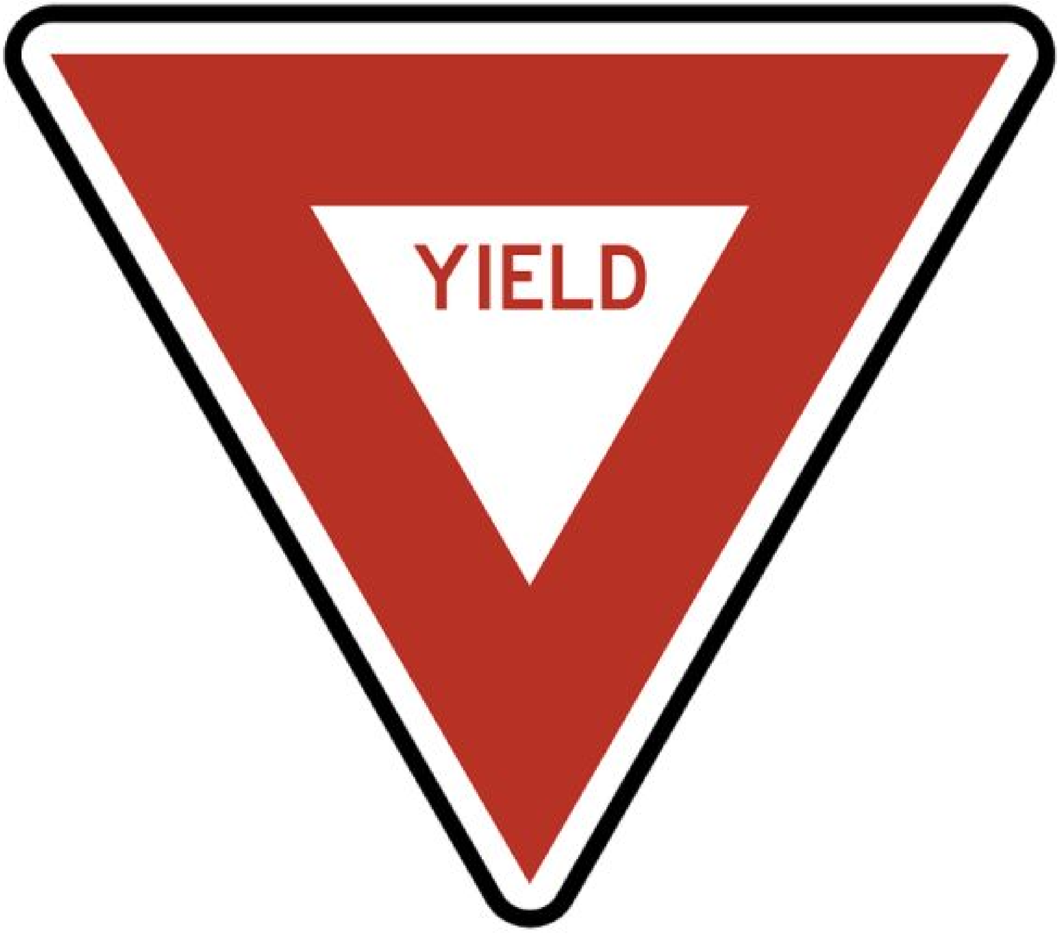
The rollout of the vaccine globally, and a continuum of ballsy global fiscal stimulus measures, along with rising prices, none the least being commodities and oil, have all taken their toll on bonds this year.

Having been caught up in this melee of bond volatility as inflation expectations continue to rise, the Australian bond market was marked down approximately -3.5% in February (in price terms) suffering its biggest negative monthly return since 1983.

Together with its negative return in January, bonds' most recent antics have put paid to recent performance, having wiped -80% off the bond market's 2020 returns.

Global bond yields rose, with the US 10-year government bond yield rising 37bp to 1.46%, and as of Friday night up to 1.64%.

Closer to home, we've witnessed the rapid rise in long bond yields during 2021, with the ten-year Australian Government bond yield having almost tripled since the lows experienced in 2020. The stock market is scratching its head, and trying to second guess what will happen next.



Enter the inflation Jeannie

Confused by all these gyrations heightened talk around inflation? You should be, as so is everyone else. Inflation expectations are many times higher than the low point experienced in March 2020 and have now crept up into the RBA inflation rate target.

Here in Australia, cash rate expectations suggest an RBA cash rate of 3% by late 2028. As at March 12, with three- and ten-year Australian Government bond yields at 0.106% and 1.79% respectively, there is an embedded expectation that cash rates will rise very quickly, surpassing pre-covid monetary policy settings into 'tight' cash rates.

Note that the RBA's monetary stimulus includes purchasing three-year bonds to hold the yield at 0.1%, while two weeks ago the central bank intervened at the ten-year level as the yield threatened to hit 2.0% in a spate of volatility.

To get an idea of exactly how quickly cash rates are expected to rise, it's important to note the market's pricing of the future path of cash rates as at 26 February 2021 is nearly three times higher than the market pricing back in October 2020.

Since the RBA began cutting the cash rate after the 2019 Federal election, UBS have been very concerned about net interest margin (NIM) pressure from the impact of low bond rates on banks' free funds and replicating portfolios. During this time, the yields on banks' replicating portfolios have reduced from around 2% to circa 1.5%.

There are still some headwinds to go, but if the yield curve steepening is sustained, UBS suspects it is likely to relieve some pressure from low rates.

Steadying the horses

Meantime, in an attempt to steady the horses, especially in light of the rise in long bond yields, which fly in the face of its commitment to yield curve control, the RBA has expanded its version of quantitative easing (QE) and recommitted to no cash rate hikes until at least 2024.

RBA Governor Lowe didn't rule out expanding QE, noting "if it turns out we need to do more, we can". This hinges on whether the RBA is making sufficient progress on reaching full employment (i.e. the non-accelerating inflation rate of unemployment or NAIRU) and the inflation target. Lowe also made it clear the RBA would use macro-prudential policy tools, rather than higher interest rates, if it needed to tame a booming housing market.

Assuming NAIRU is sub-4%, UBS thinks the implication is the RBA would rather err on the side of easing too much than too little. UBS suspects the most likely macro-prudential policy measures to be implemented are limits on high debt-to-income loans, and increasing the interest rate serviceability floor. But if there's a rapid increase in investor credit growth, other measures, adds UBS, include limits on interest-only lending and investor credit growth.

But unsurprisingly, interest rate risk - which is the sensitivity of bond markets to movements in bond yields - is now a key risk for fixed interest investors to manage. Given it is featuring a potent combination of record high levels of duration and record low bond yields, Janus Henderson claims the pre-conditions for adverse outcomes from the bond market had been brewing for a while.

As a case in point, the company believes the effect of six years of duration, essentially means that even a 1.0% rise in bond yields, would result in a -6% decline in capital for index investors.

<u>Déjà vu</u>

Those who can cast their minds back a few years may be justified in asking, as in the inimitable words of Winnie the Pooh, haven't we been here before?

The short answer is yes and no.

There are similarities between the current period and the 'taper tantrum' in 2013, and even the period of 'synchronised global growth' acceleration in 2016.

Interestingly, while Australian equities have struggled for direction in 2021, the headline performance of the index -- the ASX 200 is up around 1.2% year to date -- masks the significant performance discrepancy between sectors.

Cyclical sectors have performed strongly, whilst more defensive and high growth sectors have underperformed. Cyclical sectors (materials, energy and financials, which represent of 50% of market cap) do particularly well when bond yields are rising.

Materials have been the best performing sector due to investors wanting to position into sectors with the strongest exposure to the recovery. You only have to look to the index composition in Australia to understand why the market can keep rising while bond yields are rising.

In short, the heavyweight sectors of materials/energy and financials far outstrip the index weight of the defensive sectors.

The worst performing sectors against rising yields have historically been REITs, utilities and consumer staples (13% of the market). That's because all three have minimal earnings leverage to an acceleration in global growth.

<u>Are risk assets next?</u>

If central banks don't intervene in a coordinated fashion to avoid a 'taper tantrum' style sell-off, Janus Henderson suspects the mayhem experienced in the rates market could extend into risk assets (such as equities and high yield and investment grade credit).

Despite the asset purchase programs and dovish rhetoric from central banks, what's very clear, the investment company adds, is markets are pricing in an earlier return to the RBA tightening monetary policy than the 2024 conditional commitment Lowe & Co have made.

As a result, markets are now challenging the central banks on whether they will stay the course with forward guidance and yield curve control (YCC) measures over the next three years.

Without putting too fine a point on it, effectively navigating the more volatile rising rate environment at the key turning points will be critical, especially given the magnitude of interest rate risk (duration). So that said, how are we navigating the turmoil?

Nobody knows how much further bond yields will rise in the short term. However, given how unprecedented the speed at which yields have risen already, relative to other episodes over the last ten years, Wilsons suggests further rises in bond yields could be moderate as investors wait to see how further developments play out.

With the market unlikely to be so black and white in discriminating between covid-19 winners and losers, the broker expects stock-specific characteristics to be a more significant factor in performance.

Inflection point to value rotation trade

Whilst rotation swings in markets are never permanent, Wilson's reminds investors that it's ultimately companies that can show sustained above-market earnings growth that will help drive portfolio outperformance in the long-term.

The broker expects the current period of rotation to create opportunities among long-term growth plays that are currently unloved.

Examples include Brambles ((BXB)), Carsales ((CAR)), CSL ((CSL)), Domino's Pizza ((DMP)), NextDC ((NXT)), ResMed ((RMD)), Seek ((SEK)), and WiseTech Global ((WTC)) within the S&P/ASX 100.

Market strategists at Citi suspect there could be a turning point in the second half of FY21. While higher inflation expectations alongside better economic prospects clearly benefit cyclicals and rising bond yields favour financials, Citi reminds investors the investment community still appears underweight the non-growth elements of the equity market.

Citi's value/growth lead indicator model implies a shift occurring in the second half od FY21, which could coincide with confidence building around projections for rapid recovery. While Citi considers it too early to adjust portfolios for this growing possibility in several months' time, the broker says it's something that is worth keeping in the back of one's mind.

Citi admits the growth versus value is very vulnerable to a correction and there still seems some way to go, but the broker also believes the data look to be changing for later 2021 given the normal lags. Citi expects value EPS growth to accelerate and exceed that of its style counterpart by mid-2021.

Bond strategy

As yields rise, Janus Henderson believes it's worth taking some duration risk to capture higher yields, especially if markets overshoot.

What higher bond yields present, adds Janus Henderson, especially when cash rates are anchored at close to zero, is very steep yield curves. Hence there's an opportunity for investors to participate in both the yield and roll-down effect that adds to performance.

If nothing happens in markets over the next year, Janus Henderson believes a ten-year risk free government bond today can deliver a return that's at least twice that of a five-year major bank floating rate corporate bond.

To active managers like Janus Henderson, these are exactly the type of opportunities worth waiting for, even if some volatility in the near-term needs to be tolerated.

While they'll only know after the fact whether the strategy went too early or too late, the Janus Henderson team have also been focusing on capital preservation strategies to protect against a breakout in inflation expectations.

Janus Henderson has gradually bought into the weakening bond market, with the expectation of higher returns in the future. While a plausible case can be made for bond yields gradually lifting over the medium to long term, the investment company believes the recent sharp price action appears to have brought forward that theme too quickly.

Given the difficulty picking turning points, Janus Henderson is focussed on having the largest active position at the turning point, as it will be too late to position after markets have turned.

The investment company's sizeable allocation to inflation linked bonds helps protect portfolios against the market's expectation of a sharp lift in inflation.

Meantime, having participated in the meaningful rally of spread sectors, Janus Henderson feels it's prudent to take some profit, especially while valuations are at peak levels in the post-covid market rally.

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AUSTRALIA

Qantas On Recovery Route, Profits A Bit Longer

A vaccine, re-opening of domestic borders and a tourism support package are stimulating renewed interest in Qantas. How will this play out for a return to profit?

-Domestic borders re-opening, driving the share price
-Tourism package stimulates a rebounding leisure market
-Little impact on profitability from domestic recovery

By Eva Brocklehurst

After a torrid year is Qantas ((QAN)) on a recovery path? Several brokers believe so, as the rolling out of coronavirus vaccines provides hope the restrictions on air travel will finally be lifted.

The majority of Australian adults should have been vaccinated against covid by October and the recent government aviation support package for interstate tourism, worth $1.2bn, may support a faster domestic recovery.

UBS has gauged via its surveys that domestic borders re-opening are the most important driver of the Qantas share price and should provide impetus now as more than 90% of interstate travel is open. Interestingly, in the broker's data, the fuel price was the least important driver with 70% of respondents raking it last despite a 30% increase in the oil price this year.

In 2020 concerns centred on the balance sheet and whether people would be hesitant to fly again, as well as the Virgin Australia administration process, and UBS suggests these issues have now been de-risked. Hence, the two drivers going forward are rational domestic behaviour and Qantas achieving on its cost reduction program, ensuring costs do not return with activity.

Generally, Citi believes stimulus for various sectors during the pandemic has produced some of the best performing trades, noting fiscal support has overshot what is required, manifesting in short-term benefits for various companies.

The tourism package is no different, in that the stimulus should heat up an already rebounding leisure market. The broker has removed the High Risk rating and upgraded Qantas to Buy but tempers its enthusiasm somewhat as a leisure-led recovery is negative for the earnings mix.

Stimulus should mean capacity increases and Citi revises up available seat kilometres (ASK) assumptions but is less optimistic about cost reductions, given the company's track record.

International travel could also re-start at the end of 2021, Macquarie notes. For Qantas there are four main international destinations which traditionally account for more than 70% of ASK and the vaccine roll-out in these places may signal the shape of the recovery.

The broker is monitoring the rolling out of vaccines in the four countries that represent the largest portion of ASK - New Zealand, the US, Singapore and Hong Kong - but retains forecasts for 37/80% of pre-pandemic capacity levels in FY22/23.

Schedules are expected to start showing a step up in capacity late in the June quarter but more so during FY22. Macquarie suspects domestic capacity could overshoot pre-pandemic levels, given border policies, government stimulus and the vaccine roll-out. Regardless, the broker points out, **discounted fares may mean there is not a material improvement in earnings**.

Return To Profit

Macquarie assesses the balance sheet will start to be repaired in FY22 along with improving capacity and it is important to recognise that Qantas has structurally improved its business, with a higher skew towards a more attractive domestic and loyalty programs and cost reductions that reduce the downside risks associated with international travel.

Hence the broker re-rates the stock, upgrading to Outperform from Neutral. Ord Minnett also upgrades to Buy, believing Qantas is positioned from both a balance sheet and competitive perspective to emerge in a stronger position post the pandemic.

The broker notes costs have been taken out to provide $1bn per annum in savings from FY23 and the market position should be enhanced as Virgin Australia is a much smaller airline post administration. Ord Minnett's base case is Qantas will make $1.6bn in profit before tax in FY24, based on domestic and international ASK being back at pre-pandemic levels and a more profitable loyalty business.

Internationally, there are limited re-opening costs as many of the Qantas aircraft are already in operation. **Behaviour internationally is expected to be rational and disciplined as many international competitors have geared up throughout the crisis**.

Qantas should emerge from the pandemic with a better industry structure, given the rationalisation in Virgin Australia/Tiger Air, and as a result Morgan Stanley anticipates a return to profit in FY22. Significantly, pre-tax profit is expected to recover to FY19 levels by FY23, although demand is expected to be relatively weaker.

Citi agrees there is only negligible impact on profitability with the domestic recovery and suspects cost-conscious travellers will outweigh the high-fare corporates and this means Jetstar may over index a recovery while the Qantas brand lags.

CLSA suspects it is too early to quantify the financial benefits for Qantas of the government's tourism support package but acknowledges the steps taken to provide incentives for domestic travel.

The broker, not one of the seven stockbrokers monitored daily on the FNArena database, as a Outperform rating and $6.00 target. The database has five Buy ratings and one Sell (Credit Suisse). The consensus target is $5.79, suggesting 9.2% upside to the last share price.

Working Capital

Although ahead of the government stimulus announcement, Credit Suisse remains the outlier with an Underperform rating, noting Qantas has a large negative working capital position.

This shrank comparatively in the first half of FY21 to $6.05bn (from $7.15bn at the end of FY19) because of a -44% decline in unearned ticket revenue that offset a 21% increase in unearned loyalty revenue.

The negative working capital position over the past 15 years has varied between -$5-7bn, or 30-40% of revenue. Customers buy tickets in advance of the flight but the cost of providing the services are incurred at the time of the flight. Hence, Qantas has the benefit of cash in the interim.

Qantas also collect revenue from the sale of loyalty points to banks, retailers and other partners but consumers typically take several years to redeem these points for a flight or other item. Hence the airline effectively obtains free funding from a negative working capital position.

Given the shutdown of travel to and from Australia and a significant reduction in domestic travel over the course of the pandemic the composition of the working capital position changed. Unearned ticket revenue dropped (no one booked seats) and unearned loyalty revenue rose (consumer spending on goods increased with lockdowns).

So is this balance set to change? Credit Suisse points out a higher proportion of unearned ticket revenue relates to international travel, as these customers tend to book further in advance than domestic travellers, particularly in the leisure segment.

As international travel will take longer to recover, the broker forecasts the negative working capital position will increase out to FY24 as a recovery in unearned ticket revenue offsets a decline in unearned loyalty revenue.

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AUSTRALIA

Is CSL Ready To Turn Around?

A slump in plasma collections as a result of pandemic-induced lockdowns has put the share price of CSL under pressure. With a vaccine rolling out is it time to buy?

-Further decline in plasma collections could extend Ig shortage
-Generous US stimulus a disincentive to give blood
-Chief ongoing threat to Ig usage is new therapies for CIDP

By Eva Brocklehurst

Vaccine! Vaccine! And the market's attention turns to CSL ((CSL)), anticipating plasma collections can recover now that people are out and about more. Yet, any recovery in foot traffic has a lagged impact on finished product, and generous government stimulus may also limit the desire to return to blood donations.

Ord Minnett expects a recovery in US plasma collections by mid year, as vaccinations provide the confidence that conditions are returning to normal. A solid recovery in FY23 is anticipated, although downside risk to FY22 exists if collections contract, as could be likely, amid the latest round of generous stimulus payments in the US.

Stimulus payments are expected in American bank accounts before the end of March and this could cause a drop in collections over the next couple of months. CSL has indicated **increasing donor fees during a period when economic stimulus is being distributed has limited effectiveness**.

Given the lead time, a further downturn could mean the impending immunoglobulin shortage extends into the second half of FY22, the broker adds. As a result, Ord Minnett is less inclined to lift its recommendation even though the share price has been weak recently.

Meanwhile, there are no other perceived catalysts for the short term as the pandemic eases and few developments are expected from the R&D pipeline. UBS anticipates a recovery in plasma collections from the fourth quarter of 2021 and while a rolling out of the vaccine should assist in the recovery, this will take time.

Macquarie assesses current foot traffic is still below average at around 100 US-based collection centres. Given the lag between plasma collection and the manufacture of finished product is around nine months, the impact on revenue and earnings for CSL Behring will not be felt until the second half of FY22.

While assuming a recovery occurs at that point, Macquarie envisages downside risk in the event collection volumes do not continue to improve and sticks by its Neutral rating.

Buying Opportunity?

Morgans is confident and has upgraded to Add from Hold, believing the weakness in the share price is an opportunity to buy a high-quality business, and noting the pressure on the share price has increased over the last quarter, amid several factors including the plasma supply/demand imbalance, rising costs, US fiscal stimulus and coronavirus variants.

The broker agrees plasma collection will be the chief feature of a recovery going forward and acknowledges potential for a more protracted recovery. Morgans takes what it describes as a conservative approach to plasma collection recovery, estimating a -15% volume decline through the first half and modest improvement into the second half of FY22.

Citi also upgrades to Buy, noting CSL has been the worst performer among the large healthcare companies in the ASX200, underperforming the index by -14% over the year to date. The decline in plasma collections should normalise after the roll-out of the vaccine in the US and the broker suspects upgrades to estimates for FY23 may then follow.

Credit Suisse downgraded to Neutral in the wake of the first half results, noting the company indicated a weaker second half, and suspects plasma collections will not recover to pre-pandemic levels until mid year. Morgan Stanley, too, errs on the cautious side. While its base case is for a strong rebound in collections, this is not until FY23.

While assuming a recovery for immunoglobulin will occur, competitive risks loom for specialty products and amid less substantial increments from Seqirus, in Macquarie's view, resulting in more modest profit growth expectations out to FY23, at around 10% compared with recent years of 14%.

Morgans, on the other hand, envisages upside for Seqirus and **the potential for a severe northern hemisphere flu season at the end of the year amid increased susceptibility in the population**.

New Therapies

Ord Minnett highlights the chief threat to CSL revenue for the next few years is a potential for new therapies treating chronic inflammatory demyelinating polyneuropathy (CIDP) which, while rare, account for more than a quarter of current immunoglobulin usage.

Citi agrees there is a question regarding whether these new therapies take market share from immunoglobulin and several other issues for the medium term too, such as whether gene therapy will have a significant impact on Idelvion revenue.

Any negative news flow is likely to have a commensurate negative impact on the share price, although the broker points out at this stage it is unclear whether there will be any significant impact on the immunoglobulin market in the longer term.

FNArena's database has three Buy and four Hold ratings. The consensus target is $298.01, signalling 16.1% upside to the last share price. Targets range from $261 (Ord Minnett) to $330 (UBS).

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Aged Care Sector: Poised

Despite uncertainty following the Royal Commission, a more immediate funding response is expected to find its way to the listed providers, and likely boost FY21 earnings

-Federal government response a key catalyst for listed operators
-Payment of a RAD to deliver material boost to income
-Government funding provides revenue boost of around 1%
-RADs to provide more comfort to investors on property returns

By Mark Story

While broadly agreeing fundamental changes to the industry were required, the two Royal Commissioners undertaking the review into aged care, Briggs and Pagone, were clearly at odds on no fewer than 30% of recommendations they made.

Briggs and Pagone were clearly singing from different hymn sheets on issues relating to governance. While Pagone recommended the creation of a body that is fully independent from the government, Briggs believes reforming existing institutions would deliver reform more quickly and effectively than moving to an independent model.

At this stage, Ord Minnett suspects it's difficult to judge whether either approach is better or worse for the three major ASX-listed providers.

Both commissioners are in agreeance on refundable accommodation deposits (RAD) being phased out to be replaced with an alternative resident-funded accommodation payment.

Recommendation 142 suggests the phasing out of RADs for new residents by July 2025, and the establishment of an aged care accommodation capital facility. Given the materiality of RADs to funding structures, further details are required before the market can draw meaningful conclusions.

Assuming 142 proceeds, Jarden notes resident RAD payers would then be required to pay a daily accommodation payment. The net effect is providers would likely see a material boost to accommodation income and in Jarden's view, would provide more comfort to investors on property returns.

The government is expected to provide a comprehensive response to the Royal Commission's 148 recommendations - covering funding, quality and sustainability reforms - in the May budget. As a result, all eyes are now on the government's May budget response for clues as to both the near- and medium-term financial implications for listed providers in the sector.

However, given the level of disagreement between Briggs and Pagone, the government has been gifted sufficient 'wriggle room' with which to cherry pick the measures it wishes to adopt.

If the recent commentary distancing it from an aged care tax levy is any proxy, the government looks likely to disclose its positioning progressively on these key issues between April and May.

Recommendation 144 is for the introduction of a levy of 1% of taxable personal income, suggested to commence 1 July, 2023.

The government response: A catalyst for listed operators

While the government's future commitment to aged care hinges a lot on its response to the Royal Commission's Final Report, there's a strong expectation the $13.4bn it spends on the sector (representing around 70% of total sector revenue) will continue to grow.

Overall, Macquarie considers the government response to the Final Report a key catalyst for listed operators.

As a case in point, funding recommendations from the final report included the matching of aged care subsidy indexation to wage inflation/CPI (Recommendation 110), to negate the negative operating jaws (expense growth rate exceeds income growth rate) for providing care.

While indexation measures clearly aim to align revenue growth more closely with cost growth, Macquarie notes, employee cost growth has outpaced government funding in recent years.

Recommendation 112 is to increase the Basic Daily Care Fee (BDF) by $10 per resident per day, which is to be funded by the Federal Government. Assuming recommendation 112 is accepted and implemented on 1 July, 2021, Jarden estimates implied incremental funding to Estia Health ((EHE)) of $21.6m, Japara Healthcare ((JHC)) of $14.5m, and Regis Healthcare ((REG)) of $23.6m under this scenario.

But given the uncertainty of the recommendations being implemented by the federal government, Jarden makes no earnings per share (EPS) adjustments to forecasts. Given the two funding recommendations aim to offset rising industry costs and create a sustainable environment for providers, the broker believes there's a high probability the recommendations will be accepted.

Adding to Industry costs is likely to increase with minimum qualifications and time standards. As a case in point, recommendations 78 and 86 suggest mandatory minimum qualification for personal care workers and minimum staff time standard for residential care, respectively.

Jarden notes, although costs are likely to be a result of minimum standards, given the recommendation to index subsidies in line with wage growth, they should be matched with funding.

Meanwhile, while recommendation 68, which calls for the universal adoption of digital technology, may be another driver of additional costs, Jarden suspects the impact on listed providers would be minimal, given they're already been investing in digital operating models.

Jarden has Buy ratings on Estia Health (target price $3.20) and Japara Healthcare (target price $1.33) and an Overweight rating on Regis Healthcare (target price $2.83).

However, the broker notes, there's a key risk to the companies' investment thesis if final report recommendations and outcomes do not meet expectations for returns to meet costs of capital for investment in the residential aged care sector.

Jarden's 12 month projected returns for Estia Heathcare Japara Healthcare, and Regis Healthcare are 53.8%, 72.5%, and 43.8% respectively (see price targets above).

<u>Minimum staff time</u>

Recommendation 86 also proposes minimum staff time for residents, through the engagement of registered/enrolled nurses and personal care workers for at least 200 minutes per day for the average resident, with at least 40 minutes of that time from a registered nurse (RN).

While the current industry benchmarks indicate around 200 minutes of direct care per resident per day, the composition of current staffing may differ to minimum standards under recommendations in the final report.

In assessing the potential financial impacts of additional funding, Macquarie assumes care management is included within RN staffing, allied health is excluded from the overall calculation, and an average hourly wage of around $35/hour for RNs - and circa $25/hour for other nurses/care staff. On this basis, Macquarie calculates potential total incremental costs of around $7 per resident per day.

Based on these assumptions, Macquarie estimates additional costs associated with minimum staffing requirements would offset a large proportion (around 70%) of the $10 increase in the basic daily fee per resident. This estimation assumes care management is included within RN staffing, and allied health is excluded from overall requirements.

Based on the broker's estimates, a $1 increase in the basic daily fee per resident (holding all else equal) increases earnings (EBITDA) by 2%, 4%, and 3% for Estia, Japara and Regis respectively.

In relation to indexation, Macquarie sees positive valuation implications for all listed operators. The broker expects a 2.5% annual increase in the aged care funding instrument (ACFI) from FY22 (versus its base case at 2.0% and holding all else equal).

Macquarie is expecting to see a discounted cash flow (DCF) valuation uplifts of 22%, 50%, and 26% for Estia (price target $2.25), Japara (price target $0.80), and Regis (price target $2.10) respectively, reflecting a lower earnings (EBITDA) margin and higher gearing levels.

Within the sector, Macquarie's preference remains with Estia Health, which reflects improving occupancy trends, lower relative gearing and valuation appeal.

<u>Circuit breaker for sector funding</u>

Meanwhile, the government in its initial response to Briggs and Pagone's final report has already announced additional funding of $452m to address immediate needs, with $189m to flow to residential providers.

Instead of coinciding support efforts with its review of the final report later in the year, the government's immediate one-off payments are intended to go some way to restabilising the sector and ensuring services are maintained.

The funding on offer equates to around $760 per resident in metropolitan areas and $1,145 for those in rural, regional and remote areas. These funds are expected to be received before the end of FY21, and based on similar funding received in the December half, Ord Minnett expects to see a revenue boost for each provider to the tune of around 1%.

In light of additional government funding, the latest occupancy trends, government revenue indexation of 2.5% from FY22 onwards, and the FY22 $10 increase to the BDF, UBS now forecasts Japara to deliver a FY21 net loss of -$13m, before lifting to a small profit of $1m in FY22.

In the short-term, UBS expects Japara to benefit from second half FY21 temporary funding (UBS estimates $3m); FY22 increase to BDF, up 19% to around $62 per resident per day; and FY22 increase in indexation from 1-2% to 2-3%. But over the longer-term, the broker's investment case hinges on activity-based funding levels versus staffing/quality measures, and the continuity of RAD funding.

Overall, listed aged care stocks look relatively well positioned to leverage an improving (baby-boomer led) demand profile over the next decade. However, UBS wants to see a more definitive reform agenda before becoming overly confident about the outlook for either Japara or its two peers.

Based on UBS' DCF-derived valuation ($0.75 per share), the broker sees Japara's current share price as fairly reflecting the trade-off between a significant, long-run demand opportunity, a more challenging near-term operating environment, coupled with the regulatory uncertainty of the federal government response to Royal Commission findings within the May Budget.

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AUSTRALIA

Temple & Webster Sets The Scene Online

Temple & Webster is expected to dominate the online furniture space and therein lies an investment opportunity, although growth rates may ease back in the short term

-Leading position in a structural growth story
-Reinvestment may hamper profitability in the short term
-Highly scalable platform

By Eva Brocklehurst

Temple & Webster ((TPW)) is a distinctive business at the forefront of the nascent Australian online furniture market, with a track record of high revenue growth even before the pandemic hit.

There is some uncertainty as to how the company can cycle strong comparables throughout 2021, and this may drive volatility in the share price. Yet, while not brushing aside the risk, several brokers consider the medium-long-term opportunity substantial.

There is a structural tailwind and the company has a leading position within its category which should deliver above-market revenue growth, Goldman Sachs asserts, underscoring its Buy rating and $12.45 target, which implies a potential return of more than 18%.

Morgan Stanley initiates coverage with an Overweight rating and $14.00 target, believing current weakness is a buying opportunity, and setting aside the fact that as the business reinvests for the long-term this will affect short-term profitability.

Nevertheless, revenue growth percentages will taper off as 2021 progresses, while permanent gains from an acceleration in the online space have already been captured during the pandemic, in Macquarie's view.

The broker notes private label is now 25% of revenue which helps gross margin and fills the gaps in the ranges on offer, assessing that over the longer term private label could reach 30% of sales.

The company has called out an incremental $13m investment in inventory to drive the private-label strategy yet Goldman Sachs highlights Temple & Webster's strong balance sheet and ability to fund its growth strategy.

Sales in January were up more than 100%, Bell Potter notes, the broker forecasting sales growth of around 69% for the second half, which takes into account the cycling of significant comparables in the fourth quarter.

Still, **reinvestment into growth initiatives will ratchet higher as the company adds depth and breadth across its core categories and expands its private label**. The opportunities may be significant but Bell Potter sticks with a Hold rating and $11.75 target based on valuation.

Addressable Market

Morgan Stanley assesses the degree of opportunity stems from the potential size of the online market, estimating this will be worth $2.6bn by FY25 and implying penetration of 14.6% compared with the current 5.7%. This compares with the US and UK homewares which already have online penetration rates in that vicinity.

The broker believes temporary store closures have accelerated the migration to online purchasing. Moreover, millennials are now at the stage of establishing homes and they are more likely to purchase these products online, having grown up with the internet.

Morgan Stanley also dispels the counter argument that consumers wish to feel and experience furniture and furnishings before purchasing, asserting this is less important for categories that Temple & Webster sells, such as artworks, rugs and lighting.

Increasingly sophisticated digital content and ubiquitous customer reviews make a purchase decision online easier as well. Goldman Sachs points to broadening categories including trade & commercial as well as technologies such as mobile apps and 3D libraries.

Macquarie acknowledges longer-term earnings potential and the prospect of expanding ranges and entering new verticals and agrees, in this area, Temple & Webster has a highly scalable platform and can handle multiples of existing units.

Yet the broker has a Neutral rating and $10.90 target and remains cautious based on the level of expenditure in the category, anticipating traditional bricks & mortar operators may accelerate their online market presence as expenditure in the category normalises.

Logistics

Morgan Stanley also suspects, while the Australian population is more sparse, logistics costs should come down over time as more operators enter the market and traditional retailers invest online. Then, as Temple & Webster is a dominant online operator in this segment in Australia, it is positioned to take an outsized share of the market, already having one of the more compelling offerings.

In comparing the business to the trajectory of peer Wayfair in the US, Morgan Stanley finds that being the dominant operator helped that company experience outsized growth, and Temple & Webster has even more scale than Wayfair had at this stage in the adoption curve.

Temple & Webster offers 210,000 products or more from over 500 suppliers and Goldman Sachs agrees its networks are unlikely to be matched by competitors, in the short term at least.

Morgan Stanley forecasts margins to increase to 32.5% by FY30 from 30.6% in FY20, reflecting the benefit of distribution costs declining to 12.9% from 14.0% because of greater scale.

The broker acknowledges **e-commerce is rapidly growing and this may place pressure on logistics** although the company could also invests in parts of the logistics network that would drive down long-term unit costs.

See also, Temple & Webster Stacks Up In Furniture on February 3, 2021.

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AUSTRALIA

Metcash Spending Up On Growth

Metcash has outlined a wide ranging strategy to accelerate growth in hardware and retain recently-acquired market share in food, although the amount of expenditure is a little eye watering

-Mitre 10 to account for 80% of division sales by FY24
-Regional growth providing impetus to food division sales
-Retention of market share gains key to a re-rating

By Eva Brocklehurst

Metcash ((MTS)) has shaken the market out of its lethargy, revealing substantial growth plans for its hardware division while accelerating its supermarket refurbishments and expanding eCommerce.

Management has guided to $375m in growth capital expenditure for FY22-24, with around 60% being allocated to hardware. In tandem, the company's dividend pay-out ratio has been increased to 70% of underlying profit.

Goldman Sachs suspects first impressions were negative, because of the extent of the planned capital expenditure. Nevertheless, management appears increasingly confident in the underlying stability of the business, while the strong housing sector is being captured with increased allocations to hardware.

There was a lot to like in the briefing, although Credit Suisse acknowledges some may have issues with the amount of capital expenditure being undertaken for growth. Yet, justification can be found in the opportunities that present in hardware and, specifically, Total Tools.

The broker also notes that money is being spent on upgrading and acquiring stores, for which there is relatively more objective proof of returns. Expenditure on the digital offering could also potentially be considered a "stay in business" requirement.

Expenditure is double the level Citi had anticipated, which **rules out a capital return over the short term**.

Still, the broker is optimistic about a return on hardware because of the company's strong position in trade.

Metcash provided no specific guidance on the amount of debt funding required, although Credit Suisse notes the increased dividend pay-out should ease investor concerns regarding potential returns from the investment.

As a result, the overwhelming majority of the investment is expected to be met from operating cash flow. Execution will be critical, although Morgan Stanley highlights the new strategies are occurring at a time when the business is on a solid financial footing.

Hardware

In hardware, the company will increasingly concentrate on the Mitre 10 brand, expecting this to account for 80% of division sales by FY24. An additional nine stores per annum is targeted for Total Tools, partly franchised and partly corporate owned, adding to the current 88 store count.

Morgan Stanley is particularly positive about the hardware segment, given strong housing market conditions and the company's skew to the regions. Metcash plans to deploy $95m across FY22-24 in Total Tools, predominantly by growing the store network, with a target of 130 stores by FY25.

DIY now accounts for an increasing share of hardware sales and Metcash has noted that kitchens, bathrooms and garden were categories that drove foot traffic to its stores during the 2020 lockdowns. The company continues to focus on promoting products that are not available at Bunnings ((WES)).

Supermarkets

In the supermarket division, distribution is achieving a 6.5% growth rate and while the recent strength cannot necessarily be construed as sustainable over the long term, Credit Suisse highlights regional migration as a structural support.

Metcash intends to upgrade around 90% of the food network by 2026. Food sales growth was 4.1% in the first four months of the second half, compared with 9.5% in the first half, the drop largely a result of the loss of the 7-Eleven contract.

Still, Ord Minnett observes Metcash has gained market share from both Coles ((COL)) and Woolworths ((WOW)) in food and performed well compared with Bunnings ((WES)) as the year got underway.

The broker suspects **investment in format and price positioned the business well for a lift in traffic from the pandemic, and much of this business has been retained**. Ord Minnett also highlights a strong capital position has provided Metcash with the confidence to lift its dividend.

Liquor sales were up 20% over the four months, driven by extended consumption at home, with Macquarie asserting Australia's pandemic-driven alcohol consumption appears to be a habit hard to shake.

At-home consumption is also supported by regional growth and less travel overseas. That said, the broker believes, despite the performance of independent supermarkets exceeding expectations over 2020, market share gains are likely to "normalise" as the economy re-opens.

Morgan Stanley believes the stock's current discount to the market is too steep and retains an Overweight rating on the stock. Jarden, not one of the seven stockbrokers monitored daily on the FNArena database, also has an Overweight rating with a $3.70 target, finding the valuation attractive and believing the food business has potential in the top line that is not priced in.

The market, in the broker's view, is pricing the Metcash food division as a structurally declining business and there is scope for a re-rating if the market share gains hold. Moreover, these appear to have been more sticky than many expected as years of work on price, range and store refurbishment pay off.

Despite the dividend pay-out increase, Goldman Sachs, also not one of the seven, believes a low net debt position can be maintained over FY21-23 and there remains room for capital management, retaining a Buy rating and $4.03 target.

The database has four Buy ratings and two Hold. The consensus target is $3.91, signalling 13.2% upside to the last share price. The dividend yield on FY21 and FY22 forecasts is 4.7% and 4.4%, respectively.

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AUSTRALIA

Will Commonwealth Bank Stir Up BNPL?

Can Commonwealth Bank's entry to the BNPL industry with its own virtual card upset the current operators? Will this create churn?

-No surcharge rules likely under scrutiny again
-Marketing expenditure/demand generation less replicable
-Durability of Afterpay's fees to merchants may be an issue

By Eva Brocklehurst

Has **Commonwealth Bank** ((CBA)) thrown the Buy Now Pay Later (BNPL) fraternity a curveball? As Australia's largest retail bank expands into this segment, the issue of who ultimately pays for the service comes to the fore.

BNPL business models, or points in the transaction process where the provider makes its money, differ widely, so is there evidence yet as to what the winning strategy will be?

BNPL essentially encompasses virtual finance products for the consumer that do not attract upfront consumer fees and have fixed instalment schedules, usually fortnightly. Structural drivers include declining popularity of credit cards (which take fees/interest from the user) and rising use of debit cards (which ultimately earn via bank interchange fees) along with “card free” transactions.

BNPL providers, in order to be successful need scale, as frequency of transaction drives the business. This is why Goldman Sachs believes relatively few operators will dominate the segment in each market and **Afterpay** ((APT)) has been a winner because, as an early mover, it now has a large merchant/customer base.

For context, the broker estimates Afterpay has 47% of the BNPL customer base in Australasia and makes 76% of the industry's net transaction profits. Afterpay makes more than 90% of its revenue from merchant fees and less than 10% from late payment fees.

Commonwealth Bank's new BNPL service, which can be used anywhere that debit and credit cards are accepted, will be available for up to four million of the bank's customers.

No retailer will be charged more than current credit transaction fees. The “card”, which has a $1000 limit, will be issued to a customer's mobile digital wallet. There will be no ongoing fees and late fees of $10 will be applied for repayments.

Citi does not consider the Commonwealth Bank offering differentiated, as it essentially replicates virtual card "shop anywhere" offerings. The main concern, from the perspective of Afterpay, is the ability to use the bank's BNPL at any merchant that accepts a virtual card, which could potentially reduce Afterpay's customer traction/purchase frequency.

Marketing

The demand generation and marketing expenditure aspect in the network characteristics of Afterpay and **Zip Co** ((Z1P)) are less replicable aspects, and Citi considers consumer engagement and usage will determine whether current pricing can be sustained.

Moreover, the broker considers the online user experience in the bank offer inferior, as a user needs to enter card details versus using an Afterpay checkout button. The pay-in-4 instalments as a concept is centred on the consumer and, again, Citi does not envisage this will compete with Afterpay or Zip Co directly on the merchant side.

Morgan Stanley agrees Afterpay has protection from the sales referrals that stem from its merchant base and a well-known brand, including a branded digital checkout with merchants globally. Larger purchases can also be handled.

Fees

UBS points out the lucrative economics of BNPL, particularly in Afterpay's circumstances, were always going to attract competition. With credit interchange fees being less than 1%, the cost of Commonwealth Bank's offering is a fraction of Afterpay's, where merchant fees range from 3-7%.

This will bring into sharp focus the "no surcharge" rules that the industry has placed on consumer payment choices. UBS has survey data which indicates that **BNPL users are generally unaware of the costs to merchants for the service**.

The broker suspects the "no surcharge" rules could eventually be regulated, in line with the RBA governor's commentary last December, and the removal of these rules would be more negative for Afterpay than Zip Co, given the economics of the latter also rely on consumer fees and interest payments.

Goldman Sachs does not anticipate regulatory controls will be an issue, assessing the Afterpay business model is self-regulating. Afterpay has no recourse to the borrower and the value it lends tends to be small. The business model has limited incentive to continue lending to those customers that cannot repay.

Given the costs to a merchant from the Commonwealth Bank offering are lower, the main question Citi asks is whether Afterpay can maintain its fee structure. The durability of Afterpay's fees could ultimately depend on the size of its consumer base and consumer engagement.

Citi agrees Zip Co is less exposed from a merchant fee perspective as it generates the majority of its revenue from the consumer.

Morgan Stanley suspects the reason why Commonwealth Bank can price at standard merchant fees is its offer will be linked to a bank account, and so minimal processing costs occur on repayments.

Yet, to counter this, the broker asserts Afterpay's processing costs of around 110 basis points can be cut substantially. The Commonwealth Bank offering is limited to eligible customers so the net credit losses should be below other BNPL. On the other hand, net margins will also be materially below Afterpay's 220 basis points net margin.

Klarna

Klarna, along with Afterpay, is a market leader in the US. The Swedish company has a presence in Australia with a pay-in-4 feature through its app or anywhere Visa is accepted.

Commonwealth Bank is not entirely new as a competitor in BNPL because it has a partnership with Klarna. The instalment feature of BNPL has always had low barriers to entry, in Citi's view, and can be replicated easily.

Yet an issue for the industry is whether Commonwealth Bank's replication of the Klarna “shop anywhere” product will have a negative impact on Klarna's Australian prospects.

Citi believes Klarna is actually a bigger threat to Afterpay and Zip Co, with a superior app offering and features such as a WishList and price alerts. From Zip Co's perspective the new offer from Commonwealth Bank could reduce traction for its "Tap & Zip" customers that do not carry over a balance at the end of each month.

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COMMODITIES

Material Matters: Oil, Base Metals & Bulks

A glance through the latest expert views and predictions about commodities

-Lift in oil prices unlikely to be the start of a super cycle
-Energy transition, batteries underpin outlook for copper, nickel
-China's steel production cuts may pressure iron ore

By Eva Brocklehurst

Oil

For 2021 Citi upgrades its **oil** forecasts, envisaging Brent at US$69/bbl on average, noting it is cruising close to the US$70/bbl mark and could hit US$75/bbl or even US$80/bbl at certain times over the next few months.

The broker expects US$59/bbl for 2022 and assesses aggressive action by OPEC et al to keep more oil off the market for longer means inventory is being drawn down more rapidly than previously anticipated.

Nevertheless, while Saudi Arabia is reasserting its traditional role as a swing producer the broker suspects its stance could backfire and stimulate a stronger supply response down the line from **shale** and other producers.

Saudi Arabia's insistence on surprise tactics is particularly important at this point in time as prices have responded and facilitated the ability of many producers to meet their break-even price levels and increase hard currency earnings.

That said, the broker also points out this is not the beginning of a new super cycle for oil, and from 2023 onwards prices should return to the low US$50/bbl range. UBS also does not subscribe to the super cycle view, believing demand growth in 2021 and 2022 is above trend only because of the collapse in demand in 2020.

Yet, over the longer term the broker maintains a US$70/bbl forecasts for Brent, which is the level where supply should have enough incentive to meet the growth in demand and natural field decline.

UBS raises its Brent forecasts for 2021 to US$65.50/bbl and 2022 to US$62/bbl to reflect the market's desire to price in a faster recovery in demand and because of producers agreeing to defer increases to production.

The broker lifts expectations for oil stocks, upgrading **Woodside Petroleum** ((WPL)) to Buy as risk/reward is now more appealing, increasing earnings estimates by 8-51% for **Oil Search** ((OSH)) and **Santos** ((STO)) as well.

Citi, too, raises earnings estimates for Oil Search by 23%, the most leveraged producer in its coverage of oil. With a target of $5.27 the stock is the broker's top pick for those seeking upside exposure to oil. Under a longer-term base case at US$55/bbl Santos is Citi's top pick amongst the large cap stocks because of its higher-returning growth projects.

<u>Base Metals</u>

Macquarie has upgraded its outlook for **copper** based on the outlook for electricity and energy transition, which in turn transforms the earnings outlook for **OZ Minerals** ((OZL)) and **Sandfire Resources** ((SFR)). The broker retains a preference for OZ Minerals as it has several organic catalysts led by the Prominent Hill expansion.

The broker assesses earnings upside for OZ Minerals, boosted by gold exposure, is 40-75% over the next four years. Sandfire Resources also has upside of 50-130% over the same period, although the broker acknowledges its forecasts are coming off a low base.

Meanwhile, growth in **nickel** use in batteries is the main positive on that front, with a major impact from the middle of the decade onwards, and there are doubts about whether there will be enough available. **Western Areas** ((WSA)), over FY21, offers the greatest leverage to nickel, in the broker's view.

The company's recent capital raising should enable it to comfortably fund the Cosmos development and maintain strong exploration expenditure.

Mincor Resources ((MCR)) provides significant leverage to nickel as it resumes mining. **IGO Ltd** ((IGO)) has a positive trajectory driven by the re-basing of nickel forecasts and its gold exposure from Tropicana, with Macquarie calculating 20% upside for FY22-23.

<u>Bulks</u>

Morgan Stanley anticipates significant risk to demand for **iron ore** given China's largest steel city Tangshan's intention to cut **steel** production emissions has potential to return the market to surplus. Taking into account China's scrap share of steel at 20%, the broker calculates China's iron ore consumption could be -34-61mt lower than the 1.43bnt anticipated.

Such a decline could turn a projected seaborne market deficit in 2021 into a balanced or even oversupplied market.

If sufficient scrap is available in China, Morgan Stanley notes more steel could be produced through the electric arc furnace route, further impacting demand for iron ore. This would put significant pressure on the 62% benchmark price. Nevertheless, product premiums for pellets, lump and high-grade should remain elevated.

Macquarie disagrees, assessing the market will remain in deficit, or at the very least tight. Despite the policy risk the broker expects China's crude steel production will reach 1.09bnt this year.

The broker also suggests a decline in China's net steel exports could mean other producers in Asia increase output and thus, to some extent, iron ore consumption. Japan, South Korea and India can replace some of the Chinese steel in Asia.

Yet Morgan Stanley does not believe China's steel cuts will simply play out as a relocation of iron ore demand. Higher scrap use outside of China will have a negative effect too. The broker estimates US and European steel scrap share at 65% and 50%, respectively. If 40mt of China's crude steel production were to relocate to Europe and the US this would be a loss of some -50mt of China's iron ore demand.

Moreover, the broker believes the iron ore price will eventually be driven by its own supply/demand fundamentals. Goldman Sachs agrees a recovery in Brazilian exports along with the slowdown in steel production in China will narrow the deficit for iron ore in 2021 and now forecasts a "clear surplus" in 2022. A more sizeable surplus of around 49mt is anticipated in 2023.

The broker raises iron ore price estimates for 2021 to US$135/t but maintains 2022 forecasts at US$95/t. Although calling for a -US$50/t drop in iron ore by the end of the year, Goldman Sachs believes the ongoing recovery in global steel demand signals it is too early to become bearish on the sector.

The drop in iron ore prices is already assessed as factored into **BHP Group** ((BHP)) and **Rio Tinto** ((RIO)). The broker retains a Buy rating on the former because of strong cash flow and exposure to bullish views on **metallurgical coal**, copper and oil.

Otherwise, Goldman Sachs has Neutral ratings on **Rio Tinto** ((RIO)), **Mineral Resources** ((MIN)) and pure iron ore stocks **Fortescue Metals** ((FMG)) & **Champion Iron** ((CIA)). **Deterra Royalties** ((DRR)) is upgraded to Neutral from Sell on valuation.

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COMMODITIES

Material Matters: Aluminium, Iron Ore & Nickel

A glance through the latest expert views and predictions about commodities

-Tight supply underpins aluminium yet unlikely to persist
-Material slump in iron ore required before earnings downside
-Nickel could be in surplus till mid decade

By Eva Brocklehurst

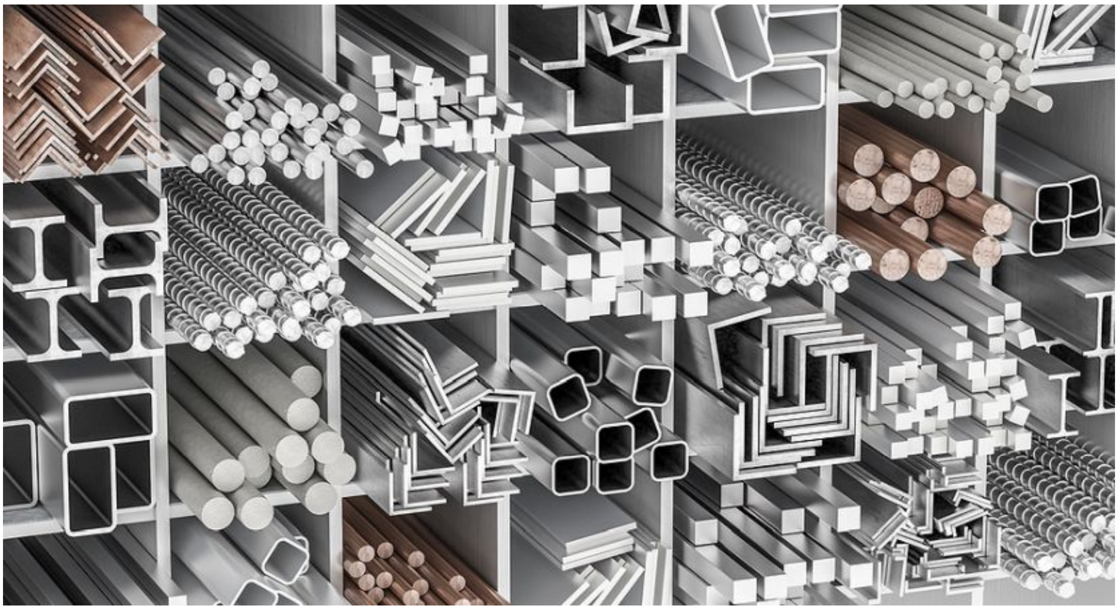
Aluminium

Morgan Stanley finds reason to be cautious about **aluminium**, noting China's production has hit a fresh high and supply growth elsewhere exists. Also, automotive production has been disrupted and the price of alumina is falling.

Still, the aluminium spot price has held up close to US$2150/t. The broker assesses speculation and a high price for **copper** are partially responsible for the resilience but there are also indications of a shortage of metal.

Restocking activity has largely supported the price and as 2021 got underway production was largely committed to contract agreements, making spot tonnage hard to find.

The broker notes scrap is in short supply as well, being affected by freight disruptions. Container freight rates have eased slightly from the highs but remain elevated and this has contributed to tight supply across the market for aluminium.



Morgan Stanley points out a large volume of the 69% of total inventory on the London Metal Exchange held in Port Klang is tied up in rent share agreements. China has also re-opened to scrap imports, reducing availability elsewhere.

Many of the drivers of the squeeze in the market are unlikely to persist through the second quarter of 2021, in the broker's view. Prices should then fall as restocking wanes, supply grows and freight constraints are lifted.

Morgan Stanley also suspects China's decarbonisation policies could have longer-term implications. The message from governments across the country has made it clear that new investment in coal-fired smelting capacity is unlikely to be approved and coal-fired power costs are going to rise.

On this basis demand could overtake primary supply growth by 2023 and China will have to consider importing aluminium, growing secondary supply and/or pushing coal-fired smelter costs up sufficiently to ensure a shift towards renewables.

Steel & Iron Ore

Since late February air quality around Beijing has been poor and a new air pollution control plan has been put in place by the Tangshan local government. The policy includes the phasing out of outdated equipment along with emission controls.

These environmental restrictions have created some uncertainty in the price of **iron ore**. UBS is unperturbed, noting Tangshan produced 144mt of **crude steel** in 2020 and the new restrictions are unlikely to affect global production in 2021 as reductions in Tangshan will be offset elsewhere. Moreover, Chinese policies still support steel demand.

Macquarie suspects steel production cuts in China could reduce exports and lead to an increase in production outside of China. If the reduction in Chinese steel production outweighs growth elsewhere then this could be bearish for iron ore demand.

On the other hand, while there is a risk prices may soften, the free cash flow of iron ore miners remains significant.

Macquarie calculates, at US$100/t, the major miners have free cash flow yields in FY22 of 7-8%, although points out the free cash flow yields of **Mineral Resources** ((MIN)) and **Champion Iron** ((CIA)) are negative because both are undertaking expenditure for growth.

In sum, Macquarie considers iron ore prices would require a material slump before there is downside to the earnings outlook. Goldman Sachs is now more convinced that **BHP Group**'s ((BHP)) Pilbara business will widen the capital expenditure, margin and cash flow to peers.

BHP's free cash flow is expected to average around US$10/t higher than **Rio Tinto** ((RIO)) and US$15/t higher than **Fortescue Metals** ((FMG)) over the next five years, underpinned by lower capital intensity and higher grades/margins.

BHP has no plans for major mine replacement for at least five years after the South Flank is completed in mid 2021. On the other hand, not only does Rio Tinto have the highest number of mines to replace, Goldman Sachs envisages greater production and expenditure risk from the Juukan Gorge incident centring on current and future heritage approvals.

BHP already has the highest operating earnings margins and the broker forecasts a long run margin of 60% compared with Rio at 56% and Fortescue at 47%. Goldman Sachs retains a Buy rating for BHP and Neutral rating on Rio and Fortescue.

Nickel

If Tsingshan expands according to plan Credit Suisse assesses **nickel** may be in surplus by over 300,000t until the middle of the decade. The company intends to lift output by around 700,000t to 1.1mtpa by 2023 which could undermine prices.

This volume is around 40% of global consumption on the broker's estimates and, while some will be supplied to the growing battery market, ferronickel for **stainless steel** will be dominant until the battery market becomes a significant consumer in the second half of the decade.

Tsingshan is also the world's largest stainless steel producer so, in Credit Suisse's opinion, its strategy is puzzling. If Tsingshan floods the market with nickel and drives down prices it would reduce its own raw material cost advantage over rivals.

Ore supply is currently the greatest constraint on Tsingshan and Credit Suisse notes another 60mtpa of wet saprolite ore is required over the next three years, which is more than the total currently supplied.

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COMMODITIES

Material Matters: Miner PEs, Iron Ore, Metals & Shale

A glance through the latest expert views and predictions about commodities: mining stock valuations; iron ore premiums; metal supply/demand; shale oil re-starts

-Miner earnings probably not yet at peak levels
-China impacts both premium and low-grade iron ore
-Recovery in demand to push up aluminium
-Significant deficit looming for copper
-Shale production recovery on the way

By Eva Brocklehurst

Super Cycle?

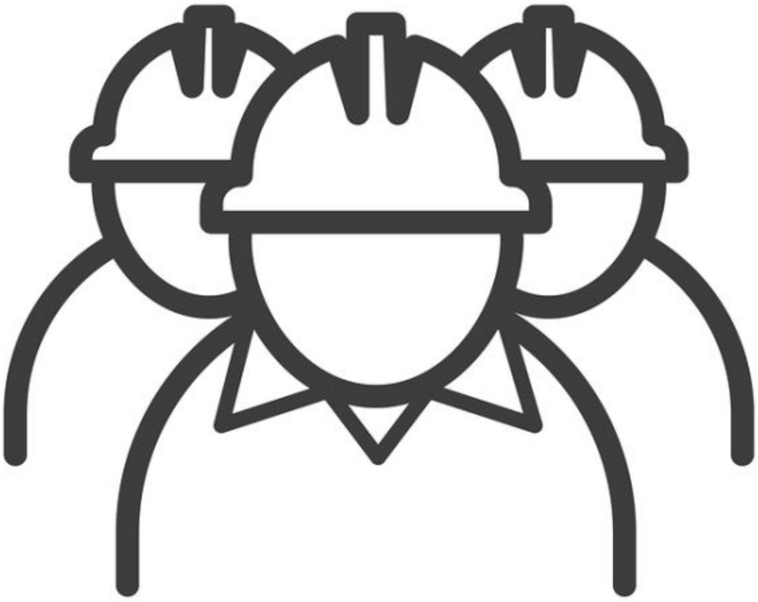
Australia's mining sector has contracted to an average of 10x consensus price/earnings (PE) and Citi notes commodity prices are, on average, well below previous peak cycle levels. Mining PEs tend to contract at commodity cycle highs, resulting in a Sell signal.

Yet, running spot commodity prices through the broker's **BHP Group** ((BHP)) and **Rio Tinto** ((RIO)) models results in a 15% increase in 2021 estimates for Rio and 41% in FY22 for BHP. Hence, the broker assesses 12-month forward earnings estimates for the mining sector have probably not yet peaked.

Historically, the earnings peak in 2008 was short lived as the financial crisis unfolded and in 2011 it was not as sharp but more prolonged. Citi assesses the industry is 12 months into a strong recovery.

Yet, this is no commodity super-cycle, nor is one forecast, the broker asserts. If the cycle is extended and **iron ore** prices do not roll down as fast as anticipated, then 2024 PEs based on normalised balance sheets could be lower still.

Looking out to 2024 and a US$75/t iron ore price, while adjusting for excess cash on the balance sheet, means 2024 PEs for BHP and Rio are at 13.3x and 10.2x, respectively.



Iron Ore

Longview Economics notes the premium for higher-grade iron ore has accelerated, reflecting the reduced availability of high-quality **coking coal** (metallurgical) from Australia in China.

The analysts point out, without Australia's high-quality product, the **steel** mills have had to increase imports of higher-quality iron ore, which requires less coke in the blast furnace. This, in turn, has driven up the premium for higher grades of iron ore.

Morgan Stanley notes, historically, the iron ore grade discount has increased and decreased in line with profitability at steel mills and, with strong demand and tight market conditions, the low-grade discount has again narrowed.

Hence, strictly enforced environmental controls such as those contemplated in Tangshan, could support mill profitability and negatively affect low-grade producers. Longview Economics notes China's efforts to be carbon neutral by 2060 could also continue to pose a risk for overall iron ore demand.

Morgan Stanley still expects China's steel demand to grow and a reduction in crude steel production could mean 2021 finished steel exports fall by -36-54mt. Other steel producing countries, with higher scrap usage and excess capacity, could take up the slack. This would lead to a more balanced iron ore market and high mill profitability, another blow for lower-grade producers.

The broker notes in 2016 when China's supply-side reforms were introduced, realisations fell to a low of 60% for **Fortescue Metals** ((FMG)) and 66% for **Mineral Resources** ((MIN)).

Subsequently, after the Vale dam disaster and amid pandemic-related stimulus, price realisations have reached 90% for Fortescue Metals and 89% for Mineral Resources. The broker's base case does not encapsulate a return to realisation lows but to 82% in FY23 for Fortescue Metals and 80% for Mineral Resources.

This means dividend yields would fall to 8% in FY22 from 13% in FY21 for Fortescue Metals and, likewise, to 4% from 7.2% for Mineral Resources.

Aluminium

Citi anticipates **aluminium** prices will rally, raising forecasts to US$2300/t to reflect tighter Chinese supply.

The boom in premiums across the globe is also supportive of a broader recovery in demand. Inner Mongolia has instituted additional smelting curtailments and prices on the Shanghai Futures Exchange have risen to decade highs as a result.

Moreover, the supply cuts have come with seasonally higher Chinese end-use demand, leading to a tight market and resulting in the opening of an import arbitrage. At present, Citi notes the market is behaving as if it is already in deficit.

Challenges exist in restocking and re-starting capacity, which the broker suggests are common themes across markets from steel to semiconductors. As a global deficit occurs in 2022, as opposed to just a regional one, Citi expects a tighter curve will drive prices on the London Metal Exchange higher and premiums lower.

Palladium

Citi expects, given **nickel** supply disruptions at Norilsk, **palladium** is likely to remain in deficit in 2021 and 2022 amid an increase in automotive production and industrial demand.

Uncertainties exist on the supply side with a slow rebound in South African production, which should further tighten the market. Visible inventory is low. The broker also suspects a recovery in global growth should attract investor flows into palladium as current positioning is tight.

Cobalt

Longview Economics notes **cobalt**, mostly use in **lithium** ion batteries, has recently hit new two-year highs. Hence, recent news flow on electric vehicles is instructive. Electric vehicle sales in Europe jumped by 137% in 2020, largely in Germany where the category reach 22% of total passenger car sales.

Longview Economics notes a shift in EV policy is also underway in China where sales grew by 12% in 2020 despite total vehicle sales falling by -4%.

Copper

A material deficit is starting to be evident in **copper** which should drive prices higher. Citi notes early indications for consumption have indicated it is around the same level as in the fourth quarter of 2020, meaning the call on scrap is at record highs. The broker suspects inventory can build for another two weeks but continues to recommend buying and adding at dips.

Wilsons agrees the copper price still has upside risk, supported by large-scale stimulus and a lack of growth in supply and believes the prospects of a tight copper market over many years is enticing.

The copper price is currently trading above US$4/lb and it could push through the price cycle peak of US$4.50/lb. The trigger should be supply disruption, which cannot be ruled out over 2021. The broker points out Chile, the world's largest source of copper, has a notoriously uncertain labour market and frequently industrial actions accompany the labour negotiation process.

Pandemic-related mine supply issues are estimated to have affected around 5% of copper volumes. Of the industrial base metals, copper has a tight demand and supply outlook through to the middle part of this decade, the broker adds.

Shale

As the **oil** price recovers, there is potential for a rapid US supply response from **shale**. Longview Economics notes Chevron reinstated its Permian oil production target of 1mbpd by 2025, to be achieved with -20% less expenditure than in pre-pandemic forecasts. Several other shale producers have also begun to increase production.

The analysts note the oil price spread to shale break-even production is now back at 2018 highs. Well completions are the most significant evidence of new production and this signals a shift in market expectations.

Nevertheless, rapid US production growth is unlikely to alter the underlying fundamentals. Even if US production rises by a record amount in 2021 Longview Economics expects the oil market will still be in deficit through to the end of the year, largely because of ongoing supply cuts from OPEC.

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ESG FOCUS

ESG Focus: Materiality Matters - Part 1

The story below has been republished to rephrase First Sentier's investment approach vis a vis the United Nations' 17 SDGs, see first sentence under Targeting UN Sustainability Goals. The original story was published on 10 March 2021.

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ESG Focus: Materiality Matters - Part 1

The highly coveted "sustainability premium" is the holy grail of ESG investors globally, and determining materiality is the key to attaining this. First Sentier shares some of its preferred metrics.

-Materiality meets "social licence" and outcomes
-Certain SDG indicators - the low-hanging fruit - come first
-Grappling with the materiality of social themes in the supply chains of emerging economies

By Sarah Mills

It is early days yet for ESG but we at FNArena are always trying to determine the more material ESG metrics to investors.

We also like to follow the money trail: where, why and when institutions are allocating their funds.

Speaking to these issues, First Sentier Investors has published a paper and held a webinar titled *Navigating Investment in a Post-Covid World.*

The paper discusses material indicators for broad sustainability, renewable energy, biodiversity, modern slavery, mental health and gender.

It also provides an interesting insight into the focus and approach of fund managers in the ESG investment space, as well as insightful information on the link between materiality and the social theme.

Part 1 of this series examines First Sentier's approach to materiality and the challenges of investing in emerging economies.

Part 2 will examine materiality in mental health, gender and modern slavery.

Part 3 will examine the environmental materiality: biodiversity, climate change, water, and oceans.

Where materiality meets outcomes

First Sentier says it focuses on both materiality and on a company's "social licence to operate" when allocating funds.

Or, as First Sentier responsible investment specialist Kate Turner puts it: "the space where materiality intersects with outcomes."

The social licence premise is that a company has a "right" to do business so long as they accept the basic rights of others to receive a living wage, breathe clean air, and drink fresh water, for example.

Social licence is becoming an increasingly material factor, and a sustainability issue, as the threat of regulation looms.

"We only invest where management operates the business effectively and in the interests of all stakeholders," says Turner.

"Those that don't look after their customers, employees, suppliers and larger community are unlikely to be rewarding long-term investments," she asserts, noting corporate failures are often indicators of low sustainability in these areas.

Social issues are also becoming increasingly material as funds pivot to invest in emerging economies with a clear growth path (as opposed to developed economies with ageing populations but reasonable working conditions).

This is particularly important given that raising standards and sustainability in emerging economies is also a focus of the UN's Social Developemnt Goals (SDG), meaning a large proportion of institutional funding will be funnelled into these economies - another revenue source for shareholders.

Given this is the case, investors are grappling with understanding the materiality of social outcomes to a company's longevity in these regions.

As an example, FSSA Investment Managers investment analyst Angus Sandison notes that the crippling of many large Indian corporations over the past few years, in particular, can be sheeted back to "social" themes.

Not only did direct investors in these companies suffer, but those with supply chain exposures to these organisations were also burnt.

So institutional focus on supply-chain management is intensifying globally.

Targeting UN Sustainability Goals

When making investment decisions, First Sentier is conscious of the United Nations' 17 SDGs, which contain 169 targets and 231 unique indicators. In this manner, the institution seeks to make its efforts more focused

The fund has chosen a handful of SDGs and then focuses on the targets and indicators upon which it feels it can have the greatest influence.

Using gender as an example, Turner notes that institutions have minimal influence over SDG indicator 5.1.1, which refers to legal frameworks to prevent sex discrimination; but it can wield strong and immediate influence on indicator 5.2.1, which relates to the percentage of women in management.

In this manner, the institution ensures its efforts are both focused and incentivised.

It rates a company according to both its negative and positive contributions to the chosen indicators.

"Every institution is likely to have its own starting points [for ESG investment]," says Turner.

"It's about seeking real world outcomes with targets and indicators."

For First Sentier, biodiversity; modern slavery; mental health; green energy and infrastructure; electrification;

decarbonisation and progression to net zero are key areas of interest and areas in which the materiality-outcomes nexus features strongly.

It views biodiversity as mutually dependent with climate change themes.

Low hanging fruit on the SDG chart

First Sentier believes it can immediately influence the following SDG target indicators.

SDG 5: Achieve gender equality and empower all women and girls Indicator 5.5.2: Proportion of women in managerial positions

SDG 8: Decent Work
Indicator 8.7.1: Proportion and number of children aged 5-17 years engaged in child labour, by sex and age (this is difficult for them to directly measure but they are working towards it)

SDG 7: Affordable and Clean Energy
Indicator 7.2.1: Renewable energy share in the total final energy consumption.

SDG 8: Decent Work
Indicator 8.7.1: Proportion and number of children aged 5-17 years engaged in child labour, by sex and age (this is difficult for them to directly measure but they are working towards it).

Indicator 8.8.1: Frequency rates of fatal and non-fatal occupational injuries, by sex and migrant status (particularly in the fund's diversified infrastructure fund portfolio)

SDG 12: Responsible Consumption and Production
Indicator 12.6.1: Number of companies publishing sustainability reports.

Given the ease of measurement, the number of women on boards is a key metric for institutions globally.

Norges Bank Investment Management, for example, has advised it will vote against the nomination committees of companies without at least two women on the board, unless they have clear plans and targets.

Last year, the investor voted against the committees of 16 European and US companies will all-male boards.

Of course, being on the board doesn't guarantee a voice, but it is a start.

Materiality of indicators

It is notable that First Sentier points out that one of its targets is, at present, difficult to measure.

The SDG indicators, are tiered as I, II and III.

Tier 1 indicators are those with an established methology and regular global data production across at least 50% of countries.

Tier II indicators have an established methodology but no regular data production.

Tier III indicators have no internationally established methodology or available standards. Which means, of course, they are, at present, ineffectual.

Given the SDGs are constantly under review and it is proposed that if no progress is made against improving measurement of Tier III indicators, those indicators will be dropped.

So investors seeking impact need to ensure their corporate investments are focused on Tier 1 indicators, particularly given they are measurable and can be used to demonstrate success, which should attract institutional funding.

Tier II indicators are generally considered satisfactory at present, but not overly material.

For example, only 34% of gender-related indicators sit in Tier 1, which means the balance is not really material.

A potential guide to greenwashing is the corporate promotion of Tier III indicators.

Tracking progress towards the SDGs

First Sentier also rewards corporate progress against SDG timelines to ensure progress towards, and accountability against, long-term ambitions.

While most SDGs are long-term goals; they include many shorter-term milestones, such as 2023, 2025, 2030, and so on.

“It’s about ensuring management teams are aligned and accountable [over the timeline],” says First Sentier.

The institution also attempts to assess how a corporation’s present actions will affect future outcomes; and then which tools are available to institutions to ensure progress.

Supply chains and the China problem

As noted above, there is a general shift to diversifying manufacturing operations out of China, in particular, and this will have serious implications for global supply chains.

This reflects in part on the nation’s continued state-sponsored human rights incursions, growing militarism, and expansion ambitions in South-East Asia.

These include the enslavement of ethnic minorities such as the Uighurs; and the murder and extraction of organs from dissidents and religious dissenters such as the Falun Gong (which has earned China a reputation as the global organ superhighway).

As mentioned in previous articles, slavery has broad economic implications; but when labour (not to mention organs) is sourced from ethnic minorities and dissidents, combined with expansionary military policies, it becomes a matter of geopolitical security.

It echoes of the rise of Hitler in Germany in the 1930s in which the nation subsumed and enslaved surrounding sovereign nations.

Many recall that that resulted in an extremely “material” war, in which vast amounts of capital were destroyed and the world order was rewritten.

In the ensuing chaos, communism extended its influence to create the Soviet bloc; China raised the bamboo curtain; the atomic bomb was dropped; and the Cold War created an uneasy balance of power that lasted nearly 40 years.

It also reflects a shift in focus to latent opportunity in lagging economies.

Investing in emerging economies

The United States has expressed a clear preference for corporations with onshore operations, and may regulate to this effect.

Corporations meanwhile, are considering their options in India, and Latin America.

But investing in emerging economies is increasingly a risk issue for investors as growth in developed economies tapers off and geopolitical tensions rise.

Weaknesses in supply chains due to slavery and poor treatment of staff and the resulting affects on quality control and secure supply are all material issues.

Sandison points to other risks of investing in India, and uses the generic pharma industry as an example.

“India is well known for its generic drug making industry, and is often dubbed ‘the world’s pharmacy’,” says Sandison.

“In our expectations, a lot of these companies have failed to meet international expectations in terms of quality control.”

“They are truly global corporations but meeting India’s manufacturing standards did not necessarily translate to those desired by the US/Europe.”

“As you can imagine, the consequences (for human health and shareholders), of poor quality control is devastating in pharmaceuticals.”

Sandison says this is indicative of the general mismatch between Indian and Western manufacturing standards that occur in other Indian industries; and pose high risks for investors in the region.

Sussing out sustainability in India

“As a general comment on India; there is a long-standing phrase in India about family businesses: ‘the first generation builds it, the second generation grows it and the third generation destroys it’,” says Sandison.

“Hence, when investing in India, we have always paid attention to management changes, the corporate culture, and the morale of various stakeholders.

“Perhaps more than any of the other markets in which we invest, India is where we wish to spend the most time on the ground - getting to visit businesses, speaking to management teams and network with the promoters.

“What we typically look for are companies where sustainability and stewardship is part of the DNA. “

“A good indicator for this is where we find companies which have successful transitioned to a professional management team whilst maintaining the crucial stability offered by a family’s ownership and influence.”

“It is a fine balance but can lead to great outcomes if achieved.”

As an example, Sandison points to Godrej Consumer, a 122-year-old Indian consumer goods business.

“We have regular calls with Nisa Godrej, the chairperson, and have seen our conviction increase as the company has demonstrated its responsiveness and willingness to be a leader around sustainability matters,” says Sandison.

“After expressing to us their desire to become leaders in environmentally friendly packaging solutions, we introduced Godrej to an innovative biodegradable packaging company in late 2018.

“By the time we met management again in May 2019, the company had commissioned a pilot study of alternative biodegradable packaging, signed up to the Plastic Pact and were increasingly using refillable containers, which lowered prices for customers and generated higher margins for the company.

“There are plenty of challenges ahead for Godrej, but the company's transparency, awareness and willingness to learn helps us build confidence in their ability to navigate the various business and sustainability challenges India faces.”

Social materiality

The next instalment in this series examines First Sentier’s approach to defining materiality and extracting the “sustainability premium” - as Blackrock’s Larry Fink describes it - for the social themes of gender, mental health, and modern slavery.

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ESG Focus: Carbon Imposts Barrelling Down On Australia

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Carbon Imposts Barreling Down On Australia

The European Parliament has just backed a tax on imports that haven't priced in the cost of carbon in a move soon to be followed by the US and Britain - all this as China prepares to launch its own carbon market and FitchRatings warns of sovereign downgrades for fossil-fuel producing countries.

-EU prepares for a border tax - the pilot kicks off in 2023
-Only a matter of time before metallurgical coal is replaced by hydrogen
-FitchRatings warns of sovereign downgrades

By Sarah Mills

The European Parliament's decision to back the European Union's (EU) push for a carbon border tax on imports of fossil fuel products is just one of the early salvos across the bow of sovereign nations during the energy transition.

The "carbon border adjustment mechanism" (CBAM) is imposed when a low emissions technology is displaced by an imported product using high emissions technology that hasn't priced in the equivalent cost of carbon; as set by the EU ETS market (currently about A$60/t CO2 equivalent).

The border tax applies to products such as cement, steel, energy, aluminium, refined oil, paper, glass, chemicals and fertilisers, which Credit Suisse estimates represent about 1.6% of Australia's exports to Europe.

Credit Suisse notes that metallurgical coal for steel-making and gold are Australia's main exports to Europe.

But it is only a matter of time before metallurgical coal is replaced by hydrogen for steel-making; and that other materials start to replace steel (the latter being further down the pipeline; the former being as early as 2025 – only two years after the CBAM pilot scheme - although Australia is planning a shift to hydrogen exports).

The European tax is expected to be imitated by the United States and Britain in the not-too-distant future, while China is already establishing its own national carbon market.

Credit Suisse notes 3% of Australia's exports ship to Europe; 9% to the US and UK combined; and 40% to China.

The European Commission is expected to present the details of CBAM in June, and plans to kick off a pilot scheme by early 2023.

The move follows Fitch's warning in February that countries set to cop the costs of stranded assets arising from fossil fuel exports could also expect to be downgraded in coming decades.

"*Climate change will adversely affect sovereign ratings, but intrinsic uncertainties make it challenging to robustly quantify the impact,*" Fitch Ratings says on its website.

"*We expect climate change to become a more important driver of rating changes as the effects become clearer, closer and more material.*

"*Transition risks include exposure to potentially 'stranded assets' (such as fossil fuel resources that may never be used) owing to changes in global policies, technology or consumer preferences.*

"*Countries will have varying capacities to adapt to and mitigate physical risks or diversifying economies to limit transition risks through policy changes and deploying resources and know-how.*

"*Other risks include domestic political stability, international trade relations, heightened conflict and deep changes to institutions or economic policies. There may well be 'unknown unknowns'.*"

The 20 sovereign nations with the highest ratio of net fossil fuel exports-to-GDP suffered a median net downgrade of -1.6 notches from 2015-2020, Fitch noted in its report.

None of this is new. Half the world has been warning of carbon regulation and sovereign credit-rating downgrades for years.

The Australian Federal Government and multinational fossil fuel producers have known this for decades.

Yet the Australian Federal Government has approved the Adani mine and Santos's ((STO)) CSG operations in Western Australia and Northern NSW, regardless of significant opposition, setting up the Australian taxpayer's liability for the impending losses.

Some investors will profit from the government's actions, others won't, given the very broad implications of credit downgrades on shareholdings and the economy.

Investing in Australia is increasingly becoming a game of musical chairs.

The CBAM, however, suggests that the music might stop a little earlier than planned.

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FEATURE STORIES

Australian Banks: Strong Tailwinds

Rising bond yields, rising margins, ongoing growth-to-value rotation and the prospect of higher dividends have brokers remaining bullish on the banks. But a resurgent housing market may yet prove an impediment.

-First sector earnings upgrades in six years for Australian banks
-Looser lending standards driving loan demand
-Will APRA be forced to step in once more?
-Have we seen this movie before?

By Greg Peel

"The Credit Squeeze experienced over the last six months is now expanding, with owner-occupier lending now falling alongside investor lending. UBS believes further credit tightening is "almost inevitable" post the Royal Commission final report due next year. The upcoming federal election is likely to reduce credit demand as borrowers contemplate changes to negative gearing and capital gains tax relief."

(Australian Banks: Uncertain Times, December 19, 2018)

We recall that once the dust had settled following the 2008 GFC, Australia's economy began to grow once more. Not only did Australia manage to avoid a technical recession, the wave of loan defaults anticipated by Australia's banks never materialised.

But a funny thing happened. A stock market's movement typically correlates with the strength or otherwise of the underlying economy. But as the economy rose out of the GFC, the stock market lagged. It took Wall Street three years to regain its pre-GFC high. It took the Australian market twelve years.

One major drag was the Aussie dollar, which moved above parity with the US dollar. Australia had avoided a recession from what we call the Global Financial Crisis. Americans refer to their experience as the Great Recession.

The stock market has always been the first go-to source of investment for retirement. But not post-GFC. With stock market returns muted, and interest rates still low in the wake of the GFC, retirement investors turned to property instead. The banks welcomed these investors with open arms, making borrowing as accessible as possible.

The result was a housing bubble. As the RBA became increasing concerned a housing bubble would ultimately result in a housing bust, it turned to APRA to tighten lending standards for investor loans. The risk was as rates rose, which was what the RBA was signalling at the time, investors on interest-only loans and owner-occupiers on high loan-to-value (LVR) ratios and high debt-to-income (DTI) ratios would be unable to service those loans, leading to a cascading effect when house prices began to fall.

And after two incursions from APRA to tighten lending standards, fall they did.

Then along came the Banking Royal Commission, and a bloke called Bill Shorten. Aside from the many crimes and misdemeanours the RC exposed, one element was very lax borrower scrutiny from lenders. In short, the banks were happy to simply take borrowers on their word in relation to any other debt obligations they may be carrying.

And everyone lies.

Before the final RC report was handed down it was already feared even stricter lending standards would follow, and that would only further fuel what was now becoming a "housing crisis". And it didn't help that the Labor Party was considered a shoe-in at the 2019 election, running on a platform of abolishing negative gearing.

Ironically, the RBA was forced to start cutting rates again.

History shows the May election was not Bill's finest hour. A gloating Coalition then turned its attention to a budget surplus. It appeared the housing crisis would now come to an end, although banks would still be required to lend only to those applicants deemed safely able to service their mortgage, following close scrutiny of their household balance sheets.

That, in essence, meant not lending to anyone much.

The Coalition then stopped gloating when covid hit. The risk of a renewed housing crisis, and a surge in loan defaults on everything from mortgages to business loans to credit cards, was starkly real. It was grim-faced Josh Freudenberg who had to deliver the news that the government's surplus assumptions had just gone out the window. Instead, Australia would need to go heavily into debt.

The RBA did what it could by cutting its cash rate to as good as zero, but urged the government to do even more on the fiscal side. JobKeeper, first homebuyer grants and HomeBuilder subsidies were just not going to cut it. Fearing he would go down as the Treasurer that lumbered Australia forever with record government debt, Josh had an idea.

Reverse the tightening of lending standards. Put the onus back on the borrower to be honest about other debt obligations. And it worked. Between historically low mortgage rates, government subsidies and relaxed lending rules, the housing market turned around.

Australia's average house price rose 3.0% in the December quarter when economists had forecast 1.8%. House prices rose 2.1% in the month of February, marking the fastest pace since 2003. Westpac economists believe prices in Sydney and Melbourne could rise by as much as 20% over the next two years.

Who said history never repeats?

<u>A Bumper Quarter</u>

Rising house prices imply rising demand, rising demand for houses implies rising demand for mortgages, and thus greater potential for better bank earnings, assuming the banks could exploit such demand in a low interest rate environment.

They could.

The bank earnings result season just past, in which Commonwealth Bank ((CBA)) posted its half-year result while Westpac ((WBC)), National Bank ((NAB)) and ANZ Bank ((ANZ)) posted quarterly trading updates, led to the first bank earnings upgrades since 2015.

"The February bank results season was one of the strongest in recent times," noted JP Morgan.

Not only were performances better than expected across all banks, they were better across all key bank metrics.

The biggest surprise was an improvement in net interest margins – in simple terms the spread between deposit rates and lending rates. Businesses are still reluctant to borrow while covid continues to reverberate (and JobKeeper is set to end), so all the action was in the housing market.

The banks managed to keep their variable mortgage rates unchanged in the period, instead offering teaser rates in fixed loans as well as cash-back offers in the competitive landscape. The surprise was they managed to lower their deposit rates, with term deposits now offering a handsome 0.1% (in line with the overnight cash rate and three-year bond rate).

At the end of 2020, Australia's headline CPI was running at an annual rate of 0.9%. So a one-year term deposit rate of 0.1% equates to a real rate of -0.8%.

As well as being able to attract deposits at negative real rates, the banks were also able to attract offshore funding at commensurately low rates, to the extent they have not so far had to tap into, in any meaningful way, the term funding facility offered by the RBA. The spread on funding costs to lending income allowed the banks to improve their net interest margins.

Increased demand for loans also increases bank fee income.

On the other side of the coin, and reminiscent of the post-GFC years, the banks saw a general reduction in loans in arrears. CBA continued to top up its provision against bad debts but NAB didn't, while ANZ and Westpac actually released some of their provisions. A fall in risk-weighted assets also meant solid improvements in bank capital positions.

And hence the dividend switch was turned back on.

<u>All is Forgiven</u>

What Royal Commission?

Those aforementioned crimes and misdemeanours unearthed over two years ago now seem but a distant memory since the world was turned upside down last year. The banks are nevertheless still paying remediations, but had previously provisioned sufficient funds so not to impact on earnings going forward.

One of the impacts of post-RC regulations was increased costs of scrutinising loan applications to APRA's satisfaction, but costs fell in the December quarter, with some help from Josh.

With all that had been thrown at them, the banks had been in a downward share price cycle from early 2017 but by late 2019 had managed to enjoy a path to recovery. Then from January to March last year, bank share prices fell around -30%.

We are now approaching the anniversary of the covid market bottom – March 23 – and since that time the financials sector has rebounded some 33%. That doesn't mean covid never happened, because to recover all of a -30% fall, a 43% rebound is required.

The initial rebound from last March initially reflected calls of "oversold", and then ramped up when the national lockdown ended. There followed a period of reflection and ongoing uncertainty, particularly when Melbourne went back into lockdown.

Melbourne finally emerged blinking into the sunlight just as the first vaccines were announced, at a time the government had introduced the HomeBuilder subsidy and had extended both the first homebuyers grant and JobKeeper (albeit at lower levels). Suddenly there was a global rush out of covid beneficiaries and "growth" stocks and back into cyclicals and "value" stocks – the banks being flag-wavers for the latter.

Of the 33% the banks have currently rallied by from the bottom, 29% has been since November. Positive earnings results announced in February and the return of dividends have served to help.

But are we all now a bit *too* over-excited?

<u>Don't jump off just yet</u>

All brokers acknowledge the re-rating of banks stocks to date has been significant, so the greatest gains have already been booked. But as Credit Suisse puts it, "While the cheap seats have been taken, we believe there is still upside remaining and we remain positive on the sector".

Credit Suisse notes that despite the rebound, the sector is still trading at a -21% discount to the index and typically has traded without any discount on the exit of prior crises.

Credit Suisse is far from alone.

Bank analysts, in chorus, cite four factors underpinning further potential upside for bank valuations.

1. More room for net interest margin expansion. While analysts have been surprised by the extent banks have been able to squeeze the deposit side, and access cheaper wholesale funding, they still believe the banks can squeeze out a little bit more.
2. Ongoing growth-to-value rotation. Morgan Stanley notes the bank downgrade cycle effectively began in 2014 with a pre-RC Financial System Inquiry and that cycle ended in March last year. Since 1992, there have been five sustained periods of bank outperformance, lasting between nine months and five years. At four months (since November), this one "may have only just begun".
3. Rising bond yields. Spikes in longer-dated bond yields both here and in the US, due to building inflation fears, have only been notable since the February result season. With the RBA holding all rates near zero up to three years, the yield curve now looks like the north face of K2. Borrow short and cheap (deposits, three-year wholesale funding) and lend long and comparatively expensive (mortgages). That's how banks can really make money.
4. Capital Management. Let's go back to "history never repeats". When the GFC hit, the banks were forced to raise fresh capital and put vast sums away in anticipation of a wave of loan defaults, as well as provisioning simply for possible ongoing disasters ahead. Neither of which happened, resulting in super-normal dividend payouts and additional special dividends when those funds were no longer needed. This time around the banks have again put away vast sums in anticipation of a wave of covid-related loan defaults, which so far hasn't happened. Banks are awash with capital. Here we go again.

Hence, on the expectation of further net interest margin improvement, ongoing rotation into value stocks, rising bond yields and a dividend and share buyback spree, bank analysts are all pretty confident the bank re-rating cycle is not down with yet.

FY22? Well, let's not get too far ahead of ourselves.

<u>History Repeats?</u>

There *might* nevertheless be one little hitch.

"We expect macro-prudential controls will be introduced in Australia later this year," said ANZ Bank's economists earlier this month. "A soft touch from the regulator [APRA] is likely in the first instance, followed by harder limits, most likely targeted at high debt-to-income loans".

Sound familiar?

When the Australian housing market was bubbling a few years back, APRA first applied a "soft touch" which was then followed up by harder limits. The RBA was concerned the housing bubble would turn to bust, and it did. The Royal Commission didn't help, leading to even tighter restrictions, and only Shorten's spectacular election defeat avoided a more pronounced crisis.

The RBA has been ready to raise rates at the time but did not want to be the trigger of a housing collapse. Pretty soon it was cutting rates again. And that all happened before covid.

When the banks found they didn't need all the provisions they'd put away for the GFC, after raising new capital, they gave it all away to shareholders. When the RC threatened to hit bank balance sheets hard, there was nothing left in the cupboard. One bank raised new capital, while others began winding back excessive dividend payout ratios. Earnings were again put away in provisions.

When covid hit, more money was put away. One bank was forced to raise capital, others did so "backdoor" fashion with underwritten DRPs, and all were ready to slash or even cancel dividends when APRA stepped in and told them to do so anyway. With covid seemingly tamed in Australia, already some of those provisions are being released, dividends have been restored, and talk is of increased payouts and buybacks.

Do they ever learn?

UBS believes macro-prudential policy tightening is "just a matter of timing", and will be implemented instead of rate hikes. The Council of Financial Regulators, which includes the RBA and APRA, has stated they will "continue to monitor developments" in the housing market and "consider possible responses should lending standards deteriorate and financial risk increase".

They are specifically "watching carefully" for changes in lending standards. On the basis of December quarter data, they should be somewhat anxious.

UBS reports the share of new home loans with a “high” debt-to-income ratio of 4x or above rose to a record high 59.3% in the December quarter, up from 57.7% in September. New loans with a “very high” DTI of 6x or more rose to to a record high 16.9% from 16.0%. “High” loan-to-value loans of 80% or more rose to a record 42% from 39.9%

Fuelling higher risk-taking was a tick down in the average mortgage rate to under 3%, with the “assessment rate” dropping to 5.5%.

The assessment rate is the rate banks use to determine whether a borrower is a safe credit risk or not. To be approved for a variable rate loan at 3%, a borrower must show the capacity to continue to service the mortgage were the variable rate to rise to 5.5%. In the March quarter to date, that assessment rate is now trending down towards 5%.

The result, UBS notes, is a sharp increase in borrowing capacity and thus a large rise in average loan size. The analysts suggest it would be a prudent move by the regulators to lift the assessment rate to 6%, reducing borrowing capacity by some -10-15% and “taking a lot of heat out of the market”.

Interest-only home loans, which were a specific target of APRA tightening the last time around, increased to a 19.3% share in December from 18.7% in September, but remain well below the peak in the prior bubble in excess of 40%.

The minutes of the RBA’s March meeting suggested “lending standards remain sound and it was important that they remain so in an environment of rising house prices and low interest rates. The Board concluded there were greater benefits from a stronger economy, while acknowledging the importance of closely monitoring risks in asset markets”.

UBS suggests a further increase in higher risk home loans would challenge this view. But the analysts believe the timing of macro-prudential tightening is probably still only later in the year. Critical will be the impact of the end of JobKeeper and HomeBuilder stimulus this month.

<u>All in the timing</u>

Morgan Stanley agrees in principal but is a little more relaxed in terms of timing, suggesting new macro-prudential measures are possible towards the end of 2021 but more likely to be required in 2022.

For such measures to be implemented, Morgan Stanley suggests the regulators would need to see a sustained period of strong house price growth, a strong pick-up in investor loan growth to around 10%, and a material increase in interest-only loans and high LVR and/or high DTI loans.

APRA’s primary tools have typically been caps or limits on investor and interest only loans, Morgan Stanley notes, along with other restraints on risk-taking. Measures taken by APRA in December 2014 were relatively modest and had little impact on loan growth. Measures taken in March 2017 were far more comprehensive and restrictive, weighing on loan growth.

And on bank valuations.

ANZ Bank economists point out macro-prudential controls are already being put in place in New Zealand, specifically targeting high LVRs. While the Kiwi housing market is currently running even hotter than Australia’s, it’s still food for thought.

<u>By Comparison</u>

This was the grim state of affairs back in May last year, when covid fallout was still a matter of sheer uncertainty and APRA had on that basis told the banks to either defer or significantly cut their dividends.

FNArena Major Bank Data					FY1 Forecasts				FY2 Forecasts			
Bank	B/H/S Ratio	Previous Close $	Average Target $	**% Upside to Target**	% EPS Growth	% DPS Growth	% Payout Ratio	**% Div Yield**	% EPS Growth	% DPS Growth	% Payout Ratio	**% Div Yield**
NAB	6/1/0	15.34	18.28	**19.16**	- 34.9	- 58.9	58.7	**4.5**	25.8	47.3	68.7	**6.6**
ANZ	4/2/1	15.23	19.38	**27.24**	- 40.4	- 71.3	36.8	**3.0**	25.9	100.0%	65.3	**6.8**
WBC	3/3/1	15.01	18.59	**23.87**	- 53.4	- 71.8	45.5	**3.3**	44.8	100.0%	67.0	**7.0**
CBA	1/4/2	58.70	61.45	**4.68**	- 13.4	- 31.4	70.3	**5.0**	- 3.1	8.1	78.4	**5.4**

Standing out are huge reductions in forecast earnings growth and dividend growth in year one, as well as much reduced dividend payout ratios and, subsequently, yields. But in year two, all bar CBA see swift forecast reversals.

Because CBA operates on a different accounting cycle to the other three, it had already paid its first half dividend before APRA pulled down the shutters.

Also standing out, nonetheless, are a net 14 Buy ratings from brokers (ten Hold, three Sell), based on very sizeable gaps (other than CBA) between a highly nervous market (share price) and far less pessimistic brokers (target price).

Well notch one up for the brokers, because if we fast-forward to today's table, those target price gaps have all but shut, with two banks now exceeding, even as average targets have been materially re-rated in the meantime.

FNArena Major Bank Data					FY1 Forecasts				FY2 Forecasts			
Bank	B/H/S Ratio	Previous Close $	Average Target $	**% Upside to Target**	% EPS Growth	% DPS Growth	% Payout Ratio	**% Div Yield**	% EPS Growth	% DPS Growth	% Payout Ratio	**% Div Yield**
ANZ	7/0/0	28.56	28.34	**- 0.10**	54.1	100.0%	64.5	**4.6**	0.7	7.3	68.7	**5.0**
WBC	6/1/0	24.73	25.80	**4.58**	100.0	100.0%	70.5	**5.0**	0.2	4.4	73.5	**5.2**
NAB	3/4/0	26.25	26.38	**0.53**	41.6	96.7	68.9	**4.5**	3.8	9.4	72.7	**4.9**
CBA	0/4/3	87.18	80.50	**- 7.59**	9.3	11.7	73.7	**3.8**	8.4	11.9	76.1	**4.3**

Earnings and dividend growth forecasts for year one largely match corresponding forecast for year two in the prior table, suggesting no change of heart. Forecast dividend yields are now looking a lot more familiar.

When share prices catch up to targets, typically that would prompt brokers to at least pull their ratings back to Hold. But no, Buy ratings have actually increased to a net 16 (nine Hold, three Sell). This aligns with the bullish views still held by brokers as explained above, and suggests the next move by brokers will not be to pull back ratings but to raise target prices.

Of course, CBA is back to having no Buy ratings, and sits in its permanent position as the lowest preference. This is because CBA trades at a premium to the other three, beyond broker valuations. It has done so for at least the last 20 years.

Will they ever learn?

Above CBA is a reshuffle of preferences from back in May, with ANZ Bank enjoying seven from seven Buy ratings. I think that's a first in FNArena's history, for any bank (at least as far as my memory stretches out).

And ANZ Bank has already exceeded the average target.

So all seems rosy in Bank Land, for now, as long as the housing loan market and house prices don't get too out of hand, just yet.

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WEEKLY REPORTS

Weekly Ratings, Targets, Forecast Changes - 12-03-21

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

By Mark Woodruff

Guide:

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

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

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

Summary

Period: Monday March 8 to Friday March 12, 2021
Total Upgrades: 12
Total Downgrades: 5
Net Ratings Breakdown: Buy 52.92%; Hold 39.36%; Sell 7.72%

For the week ending Friday 12 March, there were twelve upgrades and five downgrades to ASX-listed companies covered by brokers in the FNArena database.

CSL and Qantas received two upgrades apiece to ratings by separate brokers, while Treasury Wine Estates had two downgrades.

Both Morgans and Citi homed in on the extended share price underperformance for CSL and identified the decline in plasma collections as the central concern to date. Citi believes this will normalise after the vaccine rollout while Morgans sees upside for Seqirus from the potential for a bad northern hemisphere flu season.

While both brokers agree that one billion of cost-out for Qantas is a distinct positive, Ord Minnett upgrades on the basis of a global recovery and Citi due to the increased border certainty from the Australian government's targeted stimulus package.

Recent share price outperformance was integral to broker downgrades for Treasury Wine Estates. In addition, Credit Suisse cautions competition will intensify in Australia and Europe as grape supply previously destined for China competes in these markets.

For reasons explained above, Qantas and CSL had the two largest percentage rises in forecast target price for the week, by brokers in the FNArena database.

Iress also had a material increase in target price after Credit Suisse found both the share price and dividend yield so compelling it lifted the rating to Outperform from Neutral. The opportunity becomes even more attractive when the broker contemplates the benefits from the OneVue integration over time.

Galaxy Resources was atop the table for the largest percentage increase in earnings forecasts by brokers for the week, after an update on the James Bay lithium mine project in northern Quebec.

The mine is expected to have a life of 18 years based on an average production rate of 330,000tpa.

Oceanagold was next after one broker, Macquarie, updated copper price forecasts in the short-term by 20% and 30% in the medium-term to incorporate energy transition-related demand. This improved outlook triggered 9-10% upgrades to earnings forecasts for the company over FY21-FY25.

As mentioned last week, earnings upgrades for Karoon Energy flowed from solid production and cash metrics which are expected to continue in FY21.

In a business update last week, Eclipx Group signaled a surge in end-of-lease income. Macquarie notes used car market conditions remain strong and higher prices have driven forecast earnings upgrades by more than 20% for FY21.However, three other brokers temper Macquarie's enthusiasm by noting prevailing conditions are unsustainable and a reversion to mean is nigh.

Japara Healthcare suffered the largest percentage fall in forecast earnings for the week. In a review of the final report from the Royal Commission, UBS was underwhelmed by potential delays to much needed regulatory clarity until the FY22 Budget.

Zip Co was next on the table for forecast earnings downgrades after UBS reduced the rating to Sell from Neutral. While the broker remains positive about the short-term growth profile there are significant execution risks and capital requirements will continue to increase. In addition, higher bond rates may affect the cost of funding and valuation.

After six brokers assessed Western Areas in the wake of a $100m capital raise at $2.15 per share, the net result was a fall in forecast earnings. Morgans downgraded its rating to Hold from Add and now predicts more risk attached to production volumes at Forrestania than previously forecast. On the other hand, Credit Suisse considered the raise was prudent and upgraded the rating to Outperform from Neutral.

Total Buy recommendations take up 52.92% of the total, versus 39.36% on Neutral/Hold, while Sell ratings account for the remaining 7.72%.

Upgrade

ALS LTD ((ALQ)) Upgrade to Hold from Lighten by Ord Minnett .B/H/S: 4/3/0

Ord Minnett notes the highlights of ALS Ltd's latest update were a recovery in geochemistry sample flows and the acquisition of Investiga, a Brazilian pharmaceutical testing business.

An improvement in the geochemistry outlook and the ongoing global vaccination rollout has led to the broker upgrading the rating to Hold from Lighten. The target lifts to $9.80 from $8.60.

CSL LIMITED ((CSL)) Upgrade to Add from Hold by Morgans and Upgrade to Buy from Neutral by Citi .B/H/S: 3/4/0

With underperformance in the shares, no structural concerns and technicals being supportive, Morgans believes the risk/reward is more attractive for CSL and upgrades the rating to Add from Hold.

While identifying plasma collection as the main concern, the broker sees upside in Seqirus, on the potential for a bad northern hemisphere flu season. The recent flu respite may leave the population more vulnerable to more severe flu outbreaks over the medium/long term.

Morgans makes no changes to forecasts or the price target of $301.10.

Citi upgrades CSL to Buy from Neutral after a long period of share price underperformance and expects the decline in plasma collections will likely normalise after the covid vaccine rollout in the US.

The broker leaves earnings forecasts unchanged and retains the $310 target price after assuming plasma donations are back to normal by July 2020 and that mid-term plasma product demand remains unchanged.

IRESS LIMITED ((IRE)) Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 2/2/0

The share price has dropped to a level Credit Suisse considers compelling, upgrading to Outperform from Neutral. The broker concludes Iress has a defensible and recurring revenue base and there are several opportunities to drive modest earnings growth over time.

The share price now offers a 2021 dividend yield of 5%, the broker notes, attractive in the current environment amid limited downside. Target is steady at $11. As the OneVue integration progresses, Credit Suisse believes the opportunity becomes even more attractive to investors.

LINK ADMINISTRATION HOLDINGS LIMITED ((LNK)) Upgrade to Buy by Citi .B/H/S: 1/2/0

Link Administration has been "re-initiated" at Citi, hidden in a post-February sector report, and involving an upgrade to Buy from No Rating with a $5.70 price target.

On their own admission, Citi's Buy rating is a non-consensus call and a lot seems to revolve around realised value from the equity stake in PEXA.

NEWCREST MINING LIMITED ((NCM)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 7/0/0

Macquarie upgrades its copper price forecasts in the short-term by 20% and 30% in the medium-term to incorporate energy transition-related demand. The improved outlook drives an 8%-36% increase in the earnings forecasts for FY21-FY25 for Newcrest Mining.

Macquarie upgrades to Outperform rating from Neutral with the target rising to $30 from $28.

PANORAMIC RESOURCES LIMITED ((PAN)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 2/0/0

Macquarie upgrades its copper price forecasts in the short-term by 20% and 30% in the medium-term to incorporate energy transition-related demand. The improved outlook leads to a threefold rise in the earnings forecasts for Panoramic Resources over FY21-FY25.

The rating is upgraded to Outperform from Neutral with the target of 19c from 17c.

QANTAS AIRWAYS LIMITED ((QAN)) Upgrade to Buy from Hold by Ord Minnett and Upgrade to Buy from Neutral by Citi .B/H/S: 4/1/1

The global recovery is taking shape and Ord Minnett (courtesy of JPMorgan) believes Qantas is well-positioned to come out on the other end in a better shape, with both its balance sheet and competitive position underpinning that view.

Qantas has drastically reduced costs and the broker predicts -$1bn per annum less in costs will be carried forward (as permanent operational savings) from FY23 and onwards.

Price target has lifted to $6 from $5.50 while the rating is upgraded to Buy from Hold. Qantas should be making $1.6bn in profits before tax again in FY24 predicts the broker, as a base-case proposition.

On current projections, shareholders have to wait until FY23 to see the return of dividends.

With the increased border certainty from the government stimulus package, Citi upgrades to Buy from Neutral and increases the target to $6.14 from $5.47. However, a leisure led recovery is considered negative for mix, with only negligible impacts on profitability.

Separately, the broker feels a -$1bn dollar cost out should be a key upside catalyst though previous transformation programs show the company struggled to hold onto past benefits.

SEALINK TRAVEL GROUP LIMITED ((SLK)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 2/0/0

Macquarie upgrades its rating to Outperform from Neutral with the target rising to $9.50 from $8.70.

The broker upgrades its FY22-23 earnings forecasts for SeaLink Travel Group by 7-10% to reflect permanent operational changes in the marine & tourism segment, along with the realisation of synergies.

The on-time running of transit systems across both regions 3 and 6 have been sustained, highlights Macquarie, with tender opportunities available in Sydney and Melbourne.

WOODSIDE PETROLEUM LIMITED ((WPL)) Upgrade to Buy from Hold by Ord Minnett .B/H/S: 4/3/0

Following OPEC's decision to keep oil production steady, and in line with its global research partner, Ord Minnett increase its price forecasts for Brent crude oil to be in line with the forward curve, and on valuation grounds has raised its recommendation on Woodside Petroleum to Buy from Hold, and its price target is raised to $29.05 from $26.80.

The broker's 2021 Brent price forecast increases to US$60 a barrel (bbl) from US$53/bbl, and its 2022–23 forecasts also increase to US$60/bbl, while the long-run price from 2026 is unchanged at US$60/bbl.

Despite some challenges ahead for Woodside in progressing growth projects through to first production, the broker believe the higher oil price environment has come at an opportune time ahead of commercial discussions for offtake and potential asset sales.

WESTERN AREAS NL ((WSA)) Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 4/3/0

Western Areas will raise $85-100m in new equity to support Odysseus. This consists of a fully underwritten placement and up to $15m in a share purchase plan.

The capital raising has been motivated by balance sheet considerations, Credit Suisse notes, in order to have Odysseus fully funded from cash and debt and eliminating any future funding requirement from "at risk" cash flow from Forrestania.

The broker considers the capital raising prudent and upgrades to Outperform from Neutral. Target is reduced to $2.45 from $2.60.

See also WSA downgrade.

Downgrade

MAGELLAN FINANCIAL GROUP LIMITED ((MFG)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 2/4/1

Magellan Financial Group's February update shows net inflows were almost $0.7bn in December but were aided by the $726m partnership offer.

While expecting retail flows to hold up given the group's track record and distribution capabilities, Macquarie notes the flows decreased more than anticipated and expects more outflows for most of 2021.

The broker has also reduced its performance fee expectations for the half.

Macquarie downgrades to Neutral from Outperform with the target slipping to $44.50 from $52.

TREASURY WINE ESTATES LIMITED ((TWE)) Downgrade to Hold from Accumulate by Ord Minnett and Downgrade to Neutral from Outperform by Credit Suisse.B/H/S: 0/6/1

Ord Minnett downgrades Treasury Wine Estates to Hold from Accumulate following strong share price outperformance since the first-half result, with the target price rising to $11.50 from $11.

Treasury Wine Estates has entered into a long-term deal with The Wine Group to license some of Treasury’s commercial US wine brands, namely Beringer Main & Vine, Beringer Founders’ Estate, Coastal and Meridian for $100 million.

Ord Minnett notes these form part of the more than -$300m identified by Treasury Wine in 2020 to be sold as the company refocuses on premium US wine brands from its cheaper offerings.

Treasury Wine has divested around -4.5m cases of commercial wine for around $100m, in line with its strategy of concentrating on premium wine. Credit Suisse points out the earnings changes are not material across the forecast horizon.

The broker notes the share price has largely closed the valuation gap to peers and downgrades to Neutral from Outperform. Target is $11.30.

Credit Suisse also assumes competition will intensify in Australia and Europe as grape supply previously destined for China competes in these markets.

WESTERN AREAS NL ((WSA)) Downgrade to Hold from Add by Morgans .B/H/S: 4/3/0

The company announced a $100m capital raising ($85m placement/$15m SPP) at a minimum price of $2.15. This implies to Morgans more risk remaining to production volumes at Forrestania than forecast and the analyst reduces expected production and revenue.

This raising exceeds Morgans expectation of $50m and at a weaker price than forecast. The funds will be used in construction at Cosmos/Odysseus ($70m) and $30m to exploration and organic growth.

The broker lowers the rating to Hold from Add and decreases the target to $2.57 from $2.91.

See also WSA upgrade.

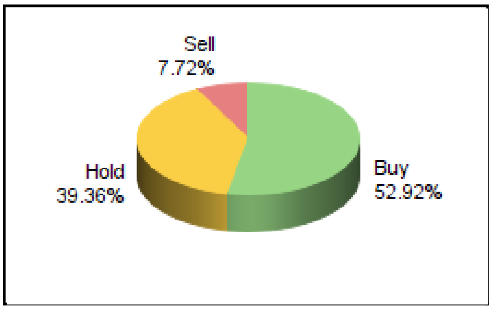
ZIP CO LIMITED ((Z1P)) Downgrade to Sell from Neutral by UBS .B/H/S: 2/1/2

Australasian customer growth surpassed rival Afterpay ((APT)) in the first half and UBS expects cash operating earnings to be at breakeven in FY21.

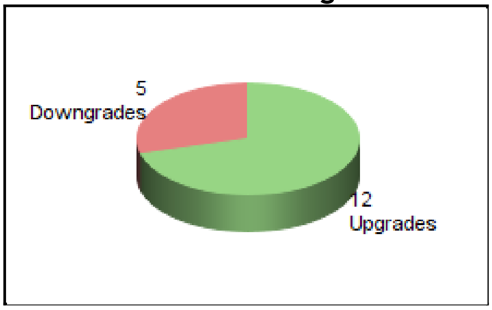
The broker remains positive about the short-term growth profile but envisages significant execution risks while capital requirements will continue to increase.

Higher bond rates may also affect the cost of funding and valuation. UBS downgrades to Sell from Neutral on valuation grounds and raises the target to $6.40 from $5.70.

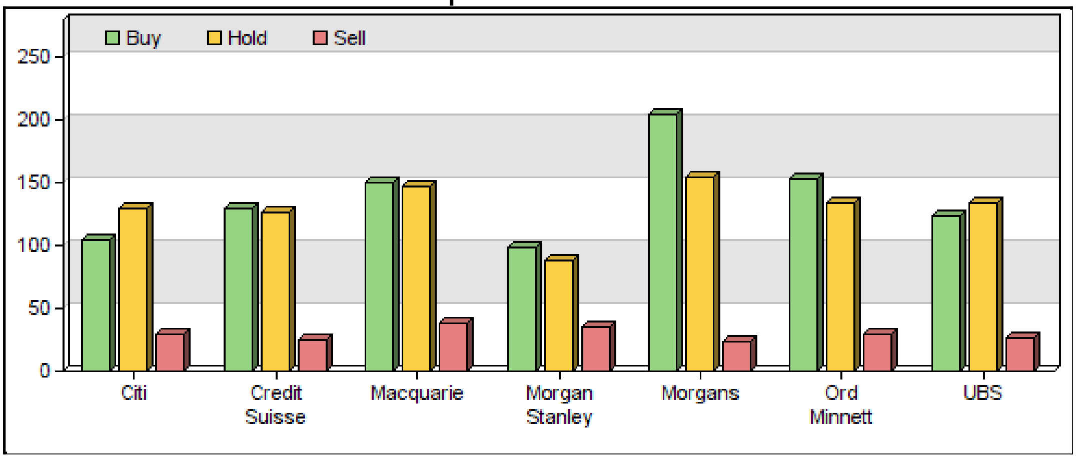
Total Recommendations



Recommendation Changes



Broker Recommendation Breakup



Broker Rating

Order	Company	New Rating	Old Rating	Broker
Upgrade				
1	ALS LTD	Neutral	Sell	Ord Minnett
2	CSL LIMITED	Buy	Neutral	Morgans
3	CSL LIMITED	Buy	Neutral	Citi
4	IRESS LIMITED	Buy	Neutral	Credit Suisse
5	LINK ADMINISTRATION HOLDINGS LIMITED	Buy	N/A	Citi
6	NEWCREST MINING LIMITED	Buy	Neutral	Macquarie
7	PANORAMIC RESOURCES LIMITED	Buy	Neutral	Macquarie
8	QANTAS AIRWAYS LIMITED	Buy	Neutral	Citi
9	QANTAS AIRWAYS LIMITED	Buy	Neutral	Ord Minnett
10	SEALINK TRAVEL GROUP LIMITED	Buy	Neutral	Macquarie
11	WESTERN AREAS NL	Buy	Neutral	Credit Suisse
12	WOODSIDE PETROLEUM LIMITED	Buy	Neutral	Ord Minnett
Downgrade				
13	MAGELLAN FINANCIAL GROUP LIMITED	Neutral	Buy	Macquarie
14	TREASURY WINE ESTATES LIMITED	Neutral	Buy	Credit Suisse
15	TREASURY WINE ESTATES LIMITED	Neutral	Buy	Ord Minnett
16	WESTERN AREAS NL	Neutral	Buy	Morgans
17	ZIP CO LIMITED	Sell	Neutral	UBS

Recommendation

Positive Change Covered by > 2 Brokers

Order	Symbol	Company	New Rating	Previous Rating	Change	Recs
1	QAN	QANTAS AIRWAYS LIMITED	50.0%	17.0%	33.0%	6
2	CSL	CSL LIMITED	43.0%	14.0%	29.0%	7
3	IRE	IRESS LIMITED	38.0%	13.0%	25.0%	4
4	IGO	IGO LIMITED	25.0%	10.0%	15.0%	4
5	SIQ	SMARTGROUP CORPORATION LTD	75.0%	60.0%	15.0%	4

6	NCM	NEWCREST MINING LIMITED	93.0%	79.0%	14.0%	7
7	WPL	WOODSIDE PETROLEUM LIMITED	57.0%	43.0%	14.0%	7
8	ARB	ARB CORPORATION LIMITED	38.0%	25.0%	13.0%	4
9	SCG	SCENTRE GROUP	-20.0%	-33.0%	13.0%	5
10	ING	INGHAMS GROUP LIMITED	80.0%	67.0%	13.0%	5

Negative Change Covered by > 2 Brokers

Order	Symbol	Company	New Rating	Previous Rating	Change	Recs
1	SM1	SYNLAIT MILK LIMITED	25.0%	50.0%	-25.0%	4
2	TWE	TREASURY WINE ESTATES LIMITED	-14.0%	7.0%	-21.0%	7
3	Z1P	ZIP CO LIMITED	-10.0%	10.0%	-20.0%	5
4	BGA	BEGA CHEESE LIMITED	83.0%	100.0%	-17.0%	3
5	AVN	AVENTUS GROUP	60.0%	75.0%	-15.0%	5
6	MFG	MAGELLAN FINANCIAL GROUP LIMITED	14.0%	29.0%	-15.0%	7
7	MND	MONADELPHOUS GROUP LIMITED	20.0%	33.0%	-13.0%	5
8	SEK	SEEK LIMITED	20.0%	33.0%	-13.0%	5
9	A2M	THE A2 MILK COMPANY LIMITED	10.0%	21.0%	-11.0%	5
10	IAG	INSURANCE AUSTRALIA GROUP LIMITED	33.0%	43.0%	-10.0%	6

Target Price

Positive Change Covered by > 2 Brokers

Order	Symbol	Company	New Target	Previous Target	Change	Recs

Negative Change Covered by > 2 Brokers

Order	Symbol	Company	New Target	Previous Target	Change	Recs

Earning Forecast

Positive Change Covered by > 2 Brokers

Order	Symbol	Company	New EF	Previous EF	Change	Recs
1	GXY	GALAXY RESOURCES LIMITED	2.095	-1.402	249.43%	4
2	OGC	OCEANAGOLD CORPORATION	13.734	7.706	78.22%	4
3	KAR	KAROON ENERGY LTD	3.233	1.867	73.17%	3
4	ECX	ECLIPX GROUP LIMITED	18.250	14.875	22.69%	4
5	DRR	DETERRA ROYALTIES LIMITED	13.868	11.995	15.61%	4
6	OZL	OZ MINERALS LIMITED	111.040	98.233	13.04%	7
7	GEM	G8 EDUCATION LIMITED	5.833	5.240	11.32%	3
8	IRE	IRESS LIMITED	41.325	37.843	9.20%	4
9	WPL	WOODSIDE PETROLEUM LIMITED	157.648	148.755	5.98%	7
10	QAN	QANTAS AIRWAYS LIMITED	-68.533	-72.433	5.38%	6

Negative Change Covered by > 2 Brokers

Order	Symbol	Company	New EF	Previous EF	Change	Recs
1	JHC	JAPARA HEALTHCARE LIMITED	-4.100	-1.850	-121.62%	4
2	Z1P	ZIP CO LIMITED	-27.660	-17.840	-55.04%	5
3	WSA	WESTERN AREAS NL	-0.167	-0.123	-35.77%	7
4	NXT	NEXTDC LIMITED	-2.407	-2.064	-16.62%	7
5	EHE	ESTIA HEALTH LIMITED	1.550	1.800	-13.89%	4
6	A2M	THE A2 MILK COMPANY LIMITED	30.164	33.626	-10.30%	5
7	APA	APA GROUP	25.160	26.346	-4.50%	7
8	BGA	BEGA CHEESE LIMITED	16.400	17.150	-4.37%	3
9	BIN	BINGO INDUSTRIES LIMITED	5.425	5.620	-3.47%	3
10	ALU	ALTIUM LIMITED	47.782	49.314	-3.11%	5

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WEEKLY REPORTS

Uranium Week: Nuclear's Sustainable Development Role

While the weekly spot uranium price remains unchanged, a new report highlights the crucial role nuclear will play for affordable energy and climate change mitigation.

-UN report outlines the way forward for nuclear
-Rosatom readies to build four reactors in China
-Spot uranium holds at $US27.40/lb.

By Mark Woodruff

A new report released by the UN Economic Commission for Europe (UNECE) highlights the crucial role for nuclear energy in providing affordable energy and climate change mitigation. In addition, it also has a role in eliminating poverty, achieving zero hunger, providing clean water as well as a part in economic growth and industry innovation.

The report was prepared by the UNECE's Expert Group on Resource Management and was supported by experts at the International Atomic Energy Agency, the OECD Nuclear Energy Agency and the World Nuclear Association.

The report addressed national and regional considerations for the nuclear fuel cycle, including the opportunities and challenges for countries wishing to utilise their local uranium resources.

In addition to noting government policy considerations, it provided a comparison of market-based and state-based funding of uranium exploration and development.

Nuclear energy is seen as a critical component of a decarbonised energy system for those member states (56) that choose to consider it as part of their sustainable development and climate change strategy.

UNECE says there are many sustainable options for implementing a nuclear fuel cycle and waste management strategy. It notes that a range of nuclear reactor designs are currently available, based on mature and proven technologies, which offer high levels of safety and outstanding operating performance.

In addition, a range of small modular reactor and advanced reactor designs are currently under development, with some ready for near-term deployment.

Company News

Russian state-owned nuclear giant **Rosatom** is expected to start construction of four reactors in China over the next two years.

Rosatom signed agreements with Chinese National Nuclear Corp in 2018 for the construction of the four VVER-1200 PWR reactors.

London listed physical uranium investment fund, **Yellow Cake plc**, has finalised negotiations to purchase 500,000 lbs of U3O8, according to industry consultant TradeTech.

Earlier this month the fund raised US$140m from investors, of which approximately US$100M will fund the acquisition of 3.5m lbs from Kazatomprom.

Uranium Pricing

TradeTech's Weekly **Spot Price** Indicator remains unchanged from the prior week's Indicator at $US27.40/lb.

The Weekly Spot Price Indicator has declined nearly -14% from a year ago and is down nearly -10% in 2021. The average weekly uranium spot price in 2021 is US$29.11/lb -US$0.60 below the 2020 average.

A total of approximately 700,000 lbs U3O8 in two transactions were reported for the week.

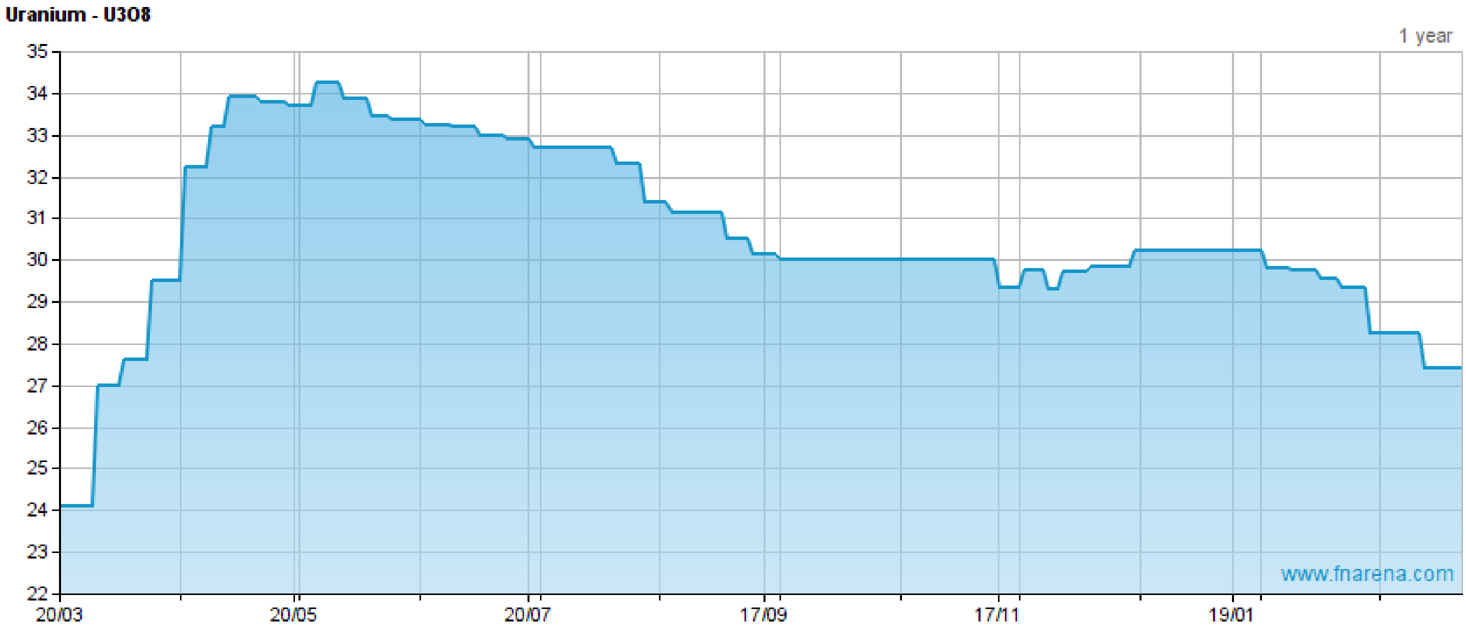
Positive signs for the market include increased liquidity, the surge in the equity market for uranium and the additional number of participants, particularly financial entities, active in the market, explains TradeTech. There is also the global recognition of the need for nuclear in order to achieve net-zero carbon emissions goals (e.g. China's 14th Five-Year Plan).

Counterbalancing this is a lack of spot buying by utilities, the drop in producer buying and what appear to be sufficient supplies to meet current demand.

Nonetheless, the fundamentals do indicate that even with increased production from Kazakhstan and a flat requirements curve there will be a need for new primary production in just a few years as in-ground production reserves are depleted.

The spot uranium market is one driven by short-term dynamics and behaviour, notes TradeTech. So although the number and type of parties willing to re-enter the spot uranium market is on the rise in 2021, fundamental data about the longer term has yet to translate into higher spot prices.

TradeTech's **term price** indicators are US$31.25/lb (mid) and US$35/lb (long).



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WEEKLY REPORTS

The Short Report - 18 Mar 2021

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

Summary:

Week ending March 11, 2021

Last week opened with the ASX200 plunging on another spike in bond yields, before completely reversing on a positive US jobs number. More saw-tooth action ensued before the index once again plunged, this time slapped down for no obvious reason from the 6800 mark.

The net result was a weaker close.

All this day to day volatility appears to be keeping the shorters at bay, or at the very least winding back positions for fear of being caught out. Not only is there a lot of green on the table below, but we now have no stocks at all in both the 8% and 9% brackets.

The net number of stocks shorted by more than 5% was unchanged from the week before - two in, two out - but there was a lot of position reduction going on.

After a positive response from its earnings result mid-February, salmon farmer Tassal Group ((TGR)) shares have done nothing but trend net lower all this month. This appears to have led to some profit-taking on shorts, given a fall last week to 11.5% shorted from 13.0%.

The only other stock to see a movement of one percentage point or more was nickel miner Western Areas ((WSA)). The nickel price has been trending down lately, ever since China announced a step-up in production, but last week the company raised new capital to fund its latest mine project.

That would explain why Western Areas shorts fell to 5.8% from 7.2%. Shorters can take profits by picking up discounted stock in the raising.

Otherwise, we note Bendigo & Adelaide Bank ((BEN)) has snuck back into the 5% table after a bit of a break, having been resident for quite some time previously.

No Movers & Shakers this week.

Weekly short positions as a percentage of market cap:

10%+
TGR 11.5
WEB 11.0

No changes

9.0-9.9

No stocks, no changes

8.0-8.9%

No stocks

Out: RSG, ING

7.0-7.9%

ING, RSG, FLT, MTS, MYR

In: ING, RSG Out: SSM, WSA, AVH

6.0-6.9%

FNP, BVS, A2M, SSM, AVH, IVC

In: SSM, AVH Out: MSB

5.0-5.9%

MSB, WSA, ALK, EOS, PNV, BEN, TPW, MP1, JBH

In: WSA, MSB, PNV, BEN Out: Z1P, CUV

ASX20 Short Positions (%)

Code	Last Week	Week Before	Code	Last Week	Week Before
ALL	0.1	0.1	MQG	0.7	0.5
ANZ	1.0	1.2	NAB	1.2	1.2
APT	1.3	1.4	NCM	0.4	0.4
BHP	3.6	3.6	RIO	0.3	0.3
BXB	0.2	0.2	TCL	0.7	0.8
CBA	0.6	0.7	TLS	0.3	0.3
COL	0.3	0.4	WBC	1.0	1.1
CSL	0.2	0.2	WES	0.5	0.5
FMG	0.5	0.4	WOW	0.3	0.4
GMG	0.2	0.4	WPL	0.8	1.0

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

Guide:

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

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

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

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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WEEKLY REPORTS

The Wrap: BoJ's Dilemma; Insurers; Travel Stocks & Bonds

Weekly Broker Wrap: BoJ's ETF dilemma; travels stock resurgence, young people shun PHI, bond yield tantrum on the cards, positive outlook for insurers' premiums, and green steel

-Are we facing a bond market tantrum? What are the potential consequences?
-Optimism growing for travel stocks, with Webjet favoured over Flight Centre
-Public debate: what should be the BoJ's strategy in the Japanese stock market?
-UBS sees margins bottoming for local insurers
-Green steel: great in concept, a lot trickier in practice

By Mark Story

Bond yields: Is there a full-blown tantrum brewing?

With global bond yields having risen sharply over recent weeks to become more in line with fair value, Oxford Economics speculates whether what started as a benign correction could evolve into a tantrum with wider consequences. Based on in-house modelling of a severe market scenario, US GDP would be -1% lower by 2022, and world GDP would be down by -0.5%.

US yields have risen by around 60bps in recent weeks, due to a surge in the term premium, indicating heightened uncertainty about growth and inflation prospects. The rise in the term premium has been similar to that which drove the “taper tantrum” sell-off in 2013.

Various factors, including the 2013 “taper tantrum” yield surge, coupled with the realisation that yields appear to have been well below equilibrium levels when the surge started, suggest to Oxford Economics the rise in yields could have further to run.

While a further increase in US yields of 50bps-70bps is seen as not out of the question, Oxford Economics suspects yields would also be likely to rise in other economies, and especially large increases are possible in some emerging markets.

For example, the experience of recent bond sell-offs suggests Europe and Asia tend to see a rise in yields of about 50bps for every 100bps increase in US yields. However, rises in emerging market yields tend to be as large, or somewhat larger, than that of US yields.

Oxford Economics forecasts in January saw US 10-year yields reaching 1.56% by the end of the year (lower than where we are now), from 0.9% at the end of 2020. But the rise in yields has come much faster than the forecaster anticipated. This is important because sudden yield surges are more likely to have disruptive effects on financial markets, such as inducing leveraged investors to sell.

The net effect of rising yields through increases to borrowing costs can directly impact growth. Then there’s the indirect impact caused by a potential sell-off in stocks globally, by diverting capital away from emerging economies, and by inducing fiscal tightening in some economies.

As well as stock market weakness, Oxford Economics believes rising US yields could cause capital flows to EM to dry up. This would magnify the impact on borrowing costs, weaken currencies (a potential problem for dollar debtors) and by driving up the US dollar, weaken commodity prices – again hitting emerging markets in particular.

The Oxford Global Model simulates a scenario in which the current sell-off evolves into a full-blown bond market tantrum. Term premia would rise back to 2013 “taper tantrum” levels, causing equity prices to fall and financial conditions to tighten.

The economic impact would be far worse if rising yields led to a tightening of fiscal policy. But the forecaster thinks this is unlikely due to rising yields having limited near-term impacts on debt servicing costs for most governments. Oxford Economics also notes while a limited economic impact is generally good news, bond holders would need to recognise that central bankers may have more tolerance for rising yields in this environment of expansionary fiscal policy.

Overall, while the forecaster still thinks the implications of a sustained rise in yields are limited for the economy, there are clear implications for bond investors. Total returns on US 10-year yields have already plunged to - 9% year on year in recent weeks.

The more worrying point, adds the forecaster, is the absence of any guarantee that central bankers will come to fixed income investors' rescue any time soon, if they remain resolutely focused on the economy and the apparent lack of an inflationary threat.

Travel: Reopening's drive recovery for Webjet and Flight Centre

With green shoots of recovery now emerging in the travel industry, Goldman Sachs assumes international travel recovery starts from mid-2021, with economies like the UK/US taking the lead, with a further strengthening over 2022.

On a pre-crisis basis (2019), direct travel spend represented around 3% of global GDP and in excess of 10.3% on an indirect basis (including job creation through related services, economic impacts in the regions). However, in 2020 direct spending reduced to around 1.7% of global GDP. According to Euromonitor, global travel spending in 2020 declined by circa -44%.

While vaccinations will help with recovery, the International Air Transport Assocation expects airline sales to return to only around 54% of 2019 levels in 2021. However, in a relative sense, IATA expects North America to see a faster recovery, with 2021 airline industry revenue forecast to be around 61% of that in 2019.

The key hurdle for the travel sector at this stage is the government-imposed restrictions. While many countries have lifted these restrictions, Goldman Sachs notes the quarantine requirements make both leisure and business travel difficult both from cost and time perspectives.

The chief medical officer in Australia commented these restrictions are likely to remain in place till the end of 2021. However, more recent comments from the federal government suggest July reopening, initially through travel hubs, such as New Zealand and Singapore.

Meantime, the broker believes that while progress on vaccinations, and possible variant outbreaks, will be the key risk to reopening programs, concerns of further flare-ups could ease significantly faster if herd immunity is achieved ahead of expectations.

While Goldman expects the covid-19 impact on the leisure market to be largely temporary, the broker sees greater uncertainty on the corporate travel market as some prior demand is likely to be adequately substituted by remote working trends.

Given the highly uncertain environment, the broker believes balance sheet strength and buffer capital to sustain through a downturn are the most important factors to watch for in a travel-exposed stock. The relative valuation pre and post-covid for individual companies, and versus the market in general, is the next key factor in Goldman's valuation framework for the travel-related stocks.

As the number two bed bank globally and Australia's leading domestic Online Travel Agent (OTA), Goldman Sachs believes Webjet ((WEB)) looks well-placed to be a structural beneficiary of the travel recovery. Given that Webjet's OTA profitability was already one of the strongest among competitors prior to covid, the broker expect this to improve as activity levels return to normal.

Goldman forecasts Webjet to post an earnings (EBITDA) compound annual growth (CAGR) of 9.5% over FY19-24, and believes the company's OTA business offers a balanced exposure to the domestic-led recovery and anticipates it will maintain a strong balance sheet.

Earnings per share (EPS) are however forecast by the broker to see a CAGR decline of -6.3% over the same period, largely as a result of the capital raise incurred in FY20. But underlying net profit CAGR forecast by Goldman is 13.7% over FY19-24. As a result, the broker initiates coverage with a Buy and a 12-month target price of $7.36 but does not expect dividends to resume till FY23.

In the meantime, while Fight Centre ((FLT)) has higher risks from exposure to international recovery in the short term, Goldman Sachs believes the company is likely to emerge post-covid with improved profitability. The broker sees major balance sheet risks for Fight Centre and initiates coverage with a Neutral rating and a price target of $20 (dividends resuming from FY24).

While Fight Centre had already started implementing strategic changes to curb cost growth, and improve focus on other business models like digital commerce, home based (independent) agents and corporate travel, the pandemic led-reset accelerated this transformation. For example, consistent with the transition to online sales, Flight Centre has already announced the closure of a significant proportion of shop fronts, guided at over 40% in A&NZ and over 50% of stores globally.

In the short term, the broker expects the corporate sector to outweigh the leisure sector for Flight Centre due to exposure to essential clients, plus the heavy exposure to domestic travel, unlike leisure where 75% of total transaction value (TTV) exposure comes from international bookings.

Since the onset of the covid crisis, Flight Centre has raised around -$900m in capital, -$200m of debt facilities, -$400m via a convertible note issue and -GBP115m via a UK-based loan.

Flight Centre had cash on hand of $1.3bn at the end of December 2020, and assuming a simple monthly cash burn of -$76m (-$71m of operating expenses, -$2m of capital expenditure and -$3m of variable costs) in line with management guidance, implies a runway of over 17 months.

However, Goldman Sachs expects cash burn to be at a slower pace as domestic activity picks up in each region. The broker also remains comfortable with Flight Centre's balance sheet position to sustain through the period of the downturn and into full recovery.

BoJ: Confront huge stockholding headache

The Bank of Japan has come under mounting criticism for the distorting effects on market pricing and corporate governance resulting from the continued expansion of its exchange traded funds (ETF) purchase program, which since 2010 has seen the central bank become the largest holder of Japanese stocks. While unrealised profits on the bank's ETF holdings fell to JPY0.3trn in March 2020, the market rebound since then has seen profits soar to an estimated at JPY15.8tn last month.

Since the BoJ started to invest in ETFs ten years ago the market value of its ETF holdings reached JPY40.5tn or 6.6% of the market capitalisation of the first section of the Tokyo stock exchange in September 2020. Since then, purchases have continued and the **BoJ is now the largest holder of Japanese stocks** exceeding the Government Pension Investment Fund.

Critics have argued the BoJ's ETF purchases are damaging price discovery by propping up stock market. This criticism has only intensified in the wake of the robust stock market recovery in recent months. Critics have also taken aim at the distortive effects on the pricing of individual stocks, which the BoJ has addressed by revising its operational procedures

For example, in 2016 the bank raised purchases of ETFs tracking the TOPIX as a share of total purchase by reducing the share of purchases of ETFs tracking the Nikkei 225, to make its operations more market neutral. Then in 2018, to address criticism that its operations could add squeeze market liquidity, the BoJ modified its stock selection benchmarks to account for the actual market availability of individual stocks rather than simply focusing on the listing's share of market capitalisation.

The rising share of the BoJ as an owner of individual stocks has also invited criticism about the possible distortive effect on corporate governance. One market analyst estimated the number of companies the BoJ indirectly owns is over 5% of total stocks, or close to 400 at the end of October 2020.

Another rising concern is that ever-increasing ETF holdings have made the BoJ's balance sheet more vulnerable to stock price volatility. To address this issue, Oxford Economics expects the central bank to reduce the pace of purchases by dropping the target amount and limiting buying to market downturns.

Unless the stock market falls into a serious downturn, these changes would effectively reduce the pace of ETF purchases. Compared to bond holdings, Oxford Economics suspects shifting ETFs off the bank's balance sheet, without risking market disruption will be challenging.

Given the already significant size of ETF holdings and the associated risks, market participants and economists are now discussing a possible exit strategy, especially how to shed ETFs from the BoJ's balance sheet without having a negative impact on the stock market.

Despite speculation about the exit strategy, including sales to individual investors or government investment funds, Oxford Economics expects the BoJ to remain silent. Meantime, BoJ Governor Kuroda is firmly sticking to his position that discussion on exit policy is premature.

The exit policy for ETF holdings is particularly tricky because, unlike bonds, stocks have no inherent expectation of redemption at maturity. Oxford Economics also notes redistributing unrealised gains or losses and risks in its ETF holdings will be contingent on unpredictable markets and require politically sensitive decisions.

But even if the pace of the BoJ's ETF purchases is effectively reduced at its next policy meeting, Oxford Economics notes the size of its ETF holdings will continue to expand, making the bank more vulnerable to market risks and the future exit policy more difficult.

[**Late news:** the BoJ is expected to announce it will cease purchasing more ETFs other than in times of market turmoil when it concludes its March policy meeting today.]

Australian Healthcare: Deteriorating value to see more younger lives exit PHI

The portion of private hospital insurance (PHI) claims contributing to the risk equalisation (RE) pool, now at 30-year highs (47.1%), reinforces the value gap for younger/healthier customers, as the average health of the pool deteriorates. As a result, Macquarie forecasts Medibank Private ((MPL)) to remain a payer to the risk equalisation pool, and nib Holdings ((NHF)) to continue selecting better risks faster than their customers' age.

The broker suspects the deteriorating value may accelerate younger lives leaving the system. While young people claim less, their premium rate growth reflects the increase in market claims due to fund's inability to risk rate lower premium rate volatility. Hence as risk equalisation (acting like reinsurance) increases, claims volatility and premium rate rises reduce across the market, and as of 1 April 2021 premium rate increases will be the lowest in 20 years.

Macquarie notes a strong correlation between Medibank's average policyholder age versus peers and the RE benefits it has been receiving. Continuing this trend, the broker estimates Medibank could contribute around -$11m to the RE pool in FY22 given the ongoing mix shift towards the younger AHM brand.

Meantime on the flipside, nib Holdings normalisation of policyholder age to industry averages is being outpaced by the insurer's ability to attract better risks. As a result, Macquarie forecasts nib's contributions to stay at a consistent percentage of total claims.

Macquarie's analysis shows that while nib's average policyholder age is converging with industry averages, the insurer's ability to attract better risks is more than offsetting the aging of the book. The broker is forecasting nib's ratio of RE contributions as a portion of total claims to revert back to pre-covid-19 trends.

The broker maintains Neutral recommendations on both Medibank Private and nib Holdings, with price targets of $2.80 and $5.45, respectively.

General Insurers: the road to recovery

A period of elevated catastrophe claims, plus a decrease in bond yields, and a drying up of reserve releases have all taken their toll on domestic insurers, which have witnessed their underlying insurance margins fall to historically low levels. Adding the sector's woes was the unique industry capital event in the name of covid-19 which also left insurers directly impacted by the need to provision for Business Interruption (BI) exposure.

However, while industry data suggest a slowing of premium rate increases in Australia, UBS expect premium rates to accelerate again in 2021 especially in property lines (home and commercial). While the road to recovery remains gradual for the insurers currently trading at price to earnings ratios well below recent years, UBS expects the sector's share prices to recover once the market gains confidence in the margin recovery.

Having analysed the key drivers of the margin outlook for Insurance Australia Group ((IAG)) and Suncorp Group ((SUN)), UBS concludes that margins – which suffered due to the unique covid-19 and lockdown environment - have likely bottomed in 1H21.

IAG and Suncorp's underlying insurance margins are at their lowest levels in over ten years, with industry losses from recent weather events and BI claims pushing reported margins down even further. However, the broker expects recovery from these levels over coming periods with upside risk, should company initiatives be delivered.

Excluding any further significant covid-19 disruption, UBS expects premium rate increases in Australian commercial lines and Australian home to be maintained or increased further over 2021. The broker also expects the large step-up in margins to come through in 2H22 and FY23, with upside risk if each of the insurers deliver on cost initiatives; achieve higher than expected premium rates; and if bond yields recover from current low levels.

IAG's margin headwind in recent years has only been around 50bps. UBS's base assumptions have IAG delivering on its 15-17% underlying margin target by FY23.

The broker's forecasts result in Suncorp falling almost -100bps below the bottom of management's 10-12% target. In the last two years the increase in Suncorp's natural hazard allowance has been a -230bps headwind in the underlying insurance margin. The company also incurred higher reinsurance costs through the purchase of additional cover, bringing the insurance margin headwind to closer to -300bps.

Having concluded that IAG's target doesn't appear overly ambitious, UBS suspects the company may not go as hard as Suncorp on premium rates in outer years in order to attract volume. But if Suncorp is to achieve the middle or upper end of its target range, the broker also suspects the operating environment would likely see IAG deliver above the top of their target.

IAG has provisioned $1.24bn (pre-tax) for potential business interruption claims, which is equivalent to a large natural peril event, without any reinsurance recovery. While there is a view that IAG has been impacted by more than its market share due to wording issues above its peers, UBS suspects this could still be an industry event of $2bn to $4bn, similar to the most costly natural peril events experience in Australia.

UBS maintains a Buy rating on both stocks, with a preference for IAG, due to the share price underperforming the ASX200 by over -30% over the last 12 months. Suncorp is currently trading around a -25% price to earnings discount to the ASX200, the low end of its -10-25% discount in the last ten years.

The broker's earnings forecasts sit -5-7% below consensus for IAG and -5-10% below for Suncorp. For Insurance Australia Group, UBS's revenue and insurance margin is only slightly below consensus.

Green Steel: Technically possible, economically challenging

With steel accounting for around 7% of global greenhouse gas emissions, there's been a heightened search for alternative production methods like "green steel" to reduce the global carbon footprint. While there is no standard definition for "green steel" it's generally described as steel that has been produced with a -90%-plus reduction in emissions intensity, versus the business as usual case today.

While green steel is technically possible, it relies on low-cost renewable power and cheap hydrogen. But given that replacing coke (coal) in the blast furnace with hydrogen (to act as an iron ore reducing agent) isn't technically possible, the only technology approaching commercial scale to produce steel from iron ore, at very low emissions, is H2-DRI/EF (which comprises fully electrolytic hydrogen-based direct reduced iron).

DRI uses either natural gas or coal to reduce iron ore. The initial step for steel makers is to convert DRI facilities to a hydrogen-based processes. The benefit of H2-DRI is it replaces all or part of the natural gas consumption with hydrogen, cutting up to -90% of the emissions.

However, the trouble with H2-DRI/EF is cost and supply. DRI plants typically use an electric furnace to produce steel and are run on high-grade iron ore pellets. But only about a quarter of global iron ore supply is in pellet form.

As a result, JP Morgan notes a significant investment in the iron ore mining industry would be required for the H2-DRI/EF route to become the solution long term.

While Greenfield capex for H2-DRI/EF is comparable to a blast furnace at $1,000-1,500/t, operating costs are around 25% ($90/t) higher at $2/kg hydrogen. JP Morgan suggests this could be (partly) overcome with green steel price premiums and carbon prices. But this assumes consumers are willing to pay a little more for products with a low carbon footprint.

It's understood the current momentum in the EU, where announced projects target circa 15Mt of green steel by 2030, could displace around -3% of seaborne met coal consumption. While this isn't yet material, JP Morgan notes that when combined with rising scrap steel availability and ESG pressure, it could start to shape portfolio decisions for miners.

JP Morgan estimates the cost to replace current (1.35bt) blast furnace production is -US$2.4trn, which is the key deployment hurdle. Overall, in the absence of high carbon prices/green premiums, the broker expects hydrogen-based steel to likely help feed new demand, rather than replace current supply of around 1.9bt.

It's worth noting that new developments are constantly being brought to market. For example, in 2019 Primetals Technology announced it had developed the world's first direct reduction process that could use iron ore concentrates from beneficiated ore.

A pilot plant is due for commissioning in the first half 2021 and should run its first campaign this year. If successful, and proven at a commercial scale, JP Morgan believes it has potential to remove the requirement for a pellet plant, which would materially reduce the capital intensity for green steel.

Earlier this year, Fortescue Metals ((FMG)) announced plans to build a "green steel" pilot plant in the Pilbara. Currently, there is test work underway to trial two green steel technologies: replacing coal in a blast furnace with green hydrogen; and molten electrolysis of iron ore using renewable electricity.

It’s understood Fortescue plans to invest in green electricity, green hydrogen, and green ammonia projects through its wholly owned subsidiary, Fortescue Future Industries (FFI). While there are no time lines, Fortescue has a vision for 300GW of renewable power projects under the FFI vehicle, and has committed to contribute around 10% of net profit (NPAT) toward FFI projects.

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RUDI'S VIEWS

Rudi's View: Are Australian Banks Back As An Indicator?

Are Australian Banks Back As An Indicator?

By Rudi Filapek-Vandyck, Editor FNArena

Pre-extreme market polarisation, I had developed my own share market indicator for the ASX, and for a while it proved rather reliable and effective.

Its composition was extremely simple and straightforward too.

I would look up each of the four major banks and compare share prices with respective consensus price targets. If there was no more room to move, or share prices were already trading above targets, this was a strong signal that market sentiment was running a bit too hot, and a pull back, at the very least, would next ensue.

It seldom took long for that pull back to follow. Yes, those were the days. Economic cycles were text-book copies. Forecasting was a lot easier. And share markets moved *en bloc*, not segment per segment, or as has been the case in recent years, along extremely polarised demarcation lines.

The big four Australian majors are still important index weights, but in a polarised market they no longer represent a weather vane for market sentiment or share market direction in general, hence I have not written about my indicator for a long while.

Remember, the sector has been in a sustainable down-trend for more than five years (from the peak in April 2015) and only climbed out of its, partially self-induced, bear market cycle late last year.

In a market that is driven by Apple, Microsoft and Tesla in the US, and by CSL, Macquarie Group and Afterpay locally, trying to draw any conclusions from share prices from the big four local banks is a waste of everybody's time. But in 2021, the banks are back, and so are insurers, builders, contractors, and other cyclicals, so maybe this means my proprietary market indicator is making a come-back too?

Bad news.

Share prices for both ANZ Bank ((ANZ)) and National Australia Bank ((NAB)) were trading slightly above consensus target last week, and have since retreated slightly. CommBank ((CBA)) usually trades at a premium and continues to do so, currently circa 7% above target. Westpac ((WBC)) shares are still trading more than -4% below target.

Throughout most of the past two decades, NAB has been the sector laggard, ever since that sorry FX trading scandal, so this is quite the familiar set-up with Westpac the new laggard and NAB back on par with ANZ Bank. What this means, all else remaining equal, is that the Value trade locally has had a big run, and banks have been at the forefront of it, but now, maybe, investors should be asking some questions about ongoing momentum and share price valuations.

Which is exactly the kind of chatter I have been picking up from corners of the local investment community here and there. It's not that there's no more room to improve for the banks, but for now, at the very least, a bit of a pause seems but appropriate.

The intriguing additional observation is that, on some momentum measurements, the correction in relative valuations between Value (the banks) and Quality & Growth (CSL and technology stocks) has reached its own extreme, placing the first group into a short-term Overbought position and Growth stocks generally in Oversold territory.

In line with market dynamics over the past five months, traders will be eyeing global bond yields to assess how long, how far, how deep, and exactly when.

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As it turns out, the reading of my personal banks-targets market indicator is not that dissimilar from **Citi's Panic/Euphoria market sentiment gauge**, which indicates investors have become too bullish and have priced assets accordingly. It is my understanding Citi's market strategists have had some deep discussions with clients over the past weeks about the exact implications of having the Panic/Euphoria reading at an all-time record high.

At face value, Citi's proprietary sentiment gauge is straightforward and pretty reliable too: when the indicator moves deeply into Panic territory there is a 96% chance for a positive return from equities over the subsequent twelve month period. When the indicator moves too far into a Euphoria reading, the odds change to a 75% chance of losing money over the year ahead.

I have been paying attention over the years because this market indicator has done a great job in picking turning points, in particular on the downside, when things look dire, but positive returns will follow (at some point) over the year ahead. Little surprise thus, the signal fell into 'Panic' early last year, and before that in late 2018. The most negative reading (deepest into Panic mode) occurred in early 2016, when the needle moved lower than in early 2009, believe it or not.

So conclusion number one is this indicator is much more reliable when pointing at too much pessimism being priced into markets and assets, as also indicated by the differences in success rates. At the top (deep into Euphoria) things have been less straightforward as also shown by the fact this indicator has been flashing warning signals, while moving ever deeper into Euphoria, since late last year. Back in the late 1990s, the reading was literally in Euphoria for multiple years, before ultimately collapsing into Panic territory as the Internet & Technology bubble burst.

Offsetting these observations are the facts this indicator flashed warning signals in early 2020 as well as in 2018, and on both occasions markets turned south pretty quickly, and violently too. Given we are as deep into Euphoria as ever recorded in the history of this indicator, with data going back to the late 1980s, strategists at Citi have made the audacious prediction that US equities are now cum a 100% historical probability of a negative return on a twelve month horizon.

For good measure, Citi's proprietary tool is not good for timing but it has historically proven a reliable indicator at both extremes of human sentiment, with a twelve month horizon. I think we can all imagine the conversations with clients that have been taking place. Despite all the push-back received, Citi strategists remain undeterred: the indicator will prove correct. History says so.

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The obvious question that arises, both from my own market indicator as with Citi's sentiment reading, as with just about every market gauge these days, is whether we are measuring a particular, popular part of the market, or the market in general.

The difference is, of course, the first scenario involves a turning point that indicates momentum will revert back from Winners into Laggards, i.e. from CBA and Fortescue Metals into ResMed and Afterpay, rather than broad-based weakness for the share market in general.

This is the mistake many investors made in mid-2018 when calls were made of too expensive share prices for companies like CSL, REA Group, Appen, and Altium, but soon after those share prices started correcting in September, the cheaper parts of the share market that had not participated in that year's rally started selling off too, until the Federal Reserve got the message and reversed policy.

This time around Citi strategists do not think share market weakness will be concentrated in banks and resources stocks only. They do think these stocks will become an integral part of the "problem" as investors are likely to push the economic recovery narrative too far, but we are probably not yet at that point.

To justify higher share prices, investors have to rely on ever more robust profit growth forecasts, and there is an obvious risk attached to that. Citi thinks herein lays the core problem. Ever more robust growth forecasts carry more risk for disappointment. The other potential risk factor is that what has been feeding this year's momentum switch into banks and resources and other cyclicals; rising bond yields.

At some point, rising bond yields, if ongoing, will cause a correction in the share market. Citi thinks the answer might be found in 'real' rates, i.e. adjusted for inflation. Global bond yields might be rising this year, they are still negative when corrected for inflation. Were 'real' rates to move closer to zero, Citi believes markets will become increasingly uncomfortable.

The same goes for central bankers who do not want normalising bond yields to undo their strategy for accommodating economies back into sustainable health. Real rates above zero equals financial tightening, hence the Federal Reserve and other central banks will be poised to increase market interventions to keep financial conditions loose and supportive.

On the other end of central bank yield controlling policies sits the US government, which is projected to borrow huge sums over the years ahead, which might require higher costs (yields).

The one factor that potentially can disrupt all good intentions is consumer price inflation. The likes of Morgan Stanley believe colleagues, peers, financial markets and central bankers are underestimating how much inflation will be generated as economies recover and gather steam in 2021.

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When it comes to earnings forecasts, Citi recently positioned itself above market consensus for the year ahead, but the strategists note the share market is pricing in an additional 5% in growth. On this basis, the strategists suspect **US ten-year treasuries at 1.75%-2% could become problematic**. On Monday, the ten year yield rose to 1.71%.

When adjusted for inflation, US bond yields are approaching the zero mark, even accounting for higher CPI readings in the months ahead. The most recent CPI reading placed headline inflation at 1.7%.

In terms of the US share market, Citi strategists believe the **S&P500 is operating within a trading range of 3600-4000**. On Friday, the index closed at 3943. Based upon the Panic/Euphoria indicator reading, and the context above, Citi strategists see it as their duty to warn of rising risk as the index approaches the top end of the range.

In terms of share market correction, the same team at Citi also runs a Bear Market Checklist that has been indicating some fluffy behaviour in parts of financial markets, but nothing as serious as had been observed in late 2007 or in 2000.

Citi strategists are therefore referring to history which has shown the typical decline after market sentiment runs up too high into Euphoria is between -9-10%.

(Paying subscribers can check share prices against price targets for more than 400 ASX-listed stocks, including the major banks via Stock Analysis on the website).

Conviction Calls

Tired of hearing about bond yields rising and how it affects prices for the likes of Xero, Goodman Group and Waypoint REIT? Fat chance, say market strategists at Morgan Stanley and Macquarie, this process of re-adjusting to this year's new economic cycle is far from finished. You are going to hear a lot more about it throughout the rest of 2021.

Morgan Stanley, concentrating on the US bond market, is projecting 1.7% by year-end, with upside bias. Macquarie, focusing on the Aussie 10-year bond, sees 2% at year-end, equally with an upside bias.

If those forecasts are correct, it means portfolio rotation and that switch in market momentum into vaccine-beneficiaries and banks and cyclicals will stay in place for longer.

Macquarie strategists have made further adjustments to their **Australian Equity Model Portfolio**, lifting exposure to insurers QBE Insurance ((QBE)) and Insurance Australia Group ((IAG)), as well as to asset manager Janus Henderson ((JHG)), on top of further buying in local financials Westpac ((WBC)), ANZ Bank ((ANZ)) and Suncorp ((SUN)).

Stocks that have been removed (sold) from the portfolio are CSL ((CSL)) and Spark Infrastructure ((SKI)), while exposure to James Hardie ((JHX)) has been reduced.

In addition, Macquarie has added Qantas ((QAN)) and Flight Centre ((FLT)) to Sydney Airport ((SYD)) to boost portfolio leverage to the upcoming travel boom with the analysts forecasting covid and border closures have created huge pent-up demand for travel and leisure that will result in a true boom period when governments decide to loosen restrictions.

The portfolio has also increased exposure to the energy sector and reduced exposure to iron ore, while Mineral Resources ((MIN)) and OZ Minerals ((OZL)) provide leverage to EV materials.

Other stocks held in the portfolio include Ramsay Health Care ((RHC)), Charter Hall ((CHC)), Telstra ((TLS)), Crown Resorts ((CWN)), Aristocrat Leisure ((ALL)), and Ampol ((ALD)). In broad terms: Macquarie's portfolio is overweight resources and underweight healthcare, staples and real estate, the typical defensives in the Australian share market.

(This story was written on Monday 15th March, 2021. 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).

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