Week
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Stories To Read From FNArena
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The Global Fiscal Panic

As global recession looms, analysts warn of a fiscal panic that will grip the world as monetary policy easing reaches its limits. Australia is not immune this time.

-End of globalisation -Massive fiscal response ahead -Inflation to return -Australia's dream run at risk

By Greg Peel

Society has reached an inflection point on several fronts, suggests Saxo Bank in its third quarter outlook, which will have profound implications for global equities. We have reached the end of globalisation as we have known it since the 1980s.

Saxo believes globalisation has reached a maximum, even before considering the US trade war with various countries that implies a big step away from globalisation in terms of free trade. Chinese manufacturing has now reached a level at which exports will cease to become any cheaper. A "massive" focus on the environmental impacts of all forms of consumption, from plastics to packaging to airline and sea transport pollution, will push up the unit cost of production.

Add in the trade war, a fiscal stimulus push into infrastructure and the shoring up of damaged global supply chains and central banks wrongly, Saxo suggests, focused on excessively low inflation, and the result is a "perfect storm" brewing that will turn back the tide of inflationary outcomes.

All of the above leads to a "massive" repeat of the 1970s global supply shock, the analysts warn.

The shock will come sometime after global fiscal expansion is unleashed in the third and fourth quarters of 2019. To this point we note many an economist has suggested QE simply hasn't worked. They cite one example as Europe's failure to drive a return to economic growth in the decade since the GFC despite doing "whatever it takes" monetarily, to quote outgoing ECB president Mario Draghi, held back by enforced post-GFC fiscal austerity.

The failure of monetary policy will lead Europe, and the rest of the global economy, into recognising the need to reverse austerity and dive into fiscal stimulus, Saxo implies. A spending spree can comfortably be funded at historically low interest rates. Such a policy comes under the banner of Modern Monetary Theory.

Australians have recently witnessed the RBA governor's plea to the federal government to provide fiscal spending support to increasingly less effective monetary policy easing. More and more commentators are despairing at the government's mindless obsession with returning the budget to surplus at a time the Australian economy is slowing and borrowing rates have never been so low.

By mid-2020, we will have seen the end of any belief in global monetary policy moving the needle, suggests Saxo, and will be witnessing "extravagant" spending driving inflation to levels beyond expectation, just a couple of quarters after inflation has been "pronounced dead".

The chance of a recession is probably much higher than global equity markets are currently reflecting, in the analysts' opinion, with yield curves and leading economic indicators sending the strongest warning signal to investors. The OECD's global economic indicator marked its 17th straight month of decline in April. History has often showed there is a final bullish move in equities despite clear evidence of an incoming recession.

That is exactly what we are witnessing today, says Saxo.

"The US Federal Reserve is playing catch-up, and, if we see material signs of weakening in the third quarter, the Fed will axe rates to the effective zero bound instantly and could even restart quantitative easing before year-end."

With US bond yields pricing in the risk of a US slowdown, and the impact of Trump's tax cuts rolling off, clearer signs of a weaker US economy should soon emerge. Saxo expects a weaker US dollar in the second half of 2019 as the Fed delivers strong easing.

This would give gold and commodities in general the tailwind they have been missing in recent years, as would a global fiscal panic leading to governments spending money they don't have. Inflation would come "roaring back".

The biggest risk to Saxo's scenario of rising commodity prices is, conversely, the potential for the US and China to actually reach a trade deal, which would likely reduce expectations of how far the Fed would need to cut.

The Wonder Downunder

Australia's near 30-year recession free run, the envy of central bankers around the globe, is now at risk, Saxo market strategist Eleanor Creagh believes. The "wonder downunder" that escaped zero interest rate policy, negative rate policy and QE will not be so lucky this time around. Monetary policy is ineffective for the challenges Australia faces.

"Monetary policy will never replace sound economic policy. So, rather than relying on central bankers to clean up the mess, the government must deliver productivity-enhancing reforms, infrastructure spending and other fiscal measures to restore confidence and start a self-sustaining recovery in economic growth."

While the RBA hopes it will not need to resort to unorthodox measures, Creagh suggests QE is not beyond the realms.

US firm T. Rowe Price believes investors need to be cautious in the near term as external risks are rising. Head of Australian Equities, Randal Jenneke, notes the Australian equity market has performed strongly in 2019 but investors have been more rewarded by lower bond yields, the unrealised risks of a Labor government or any slowdown in China's housing market than any real shift in fundamentals.

Jenneke sees this as a temporary reaction, and expects a return of focus to more fundamental factors such as ongoing US-China trade tensions and domestic housing weakness.

Concerns of a trade policy-induced global slowdown will continue to dominate markets in the short term, with potential longer term implications if other countries look to shore up greater self-sufficiency. The real danger is that of global trade grinding to a halt, which, says Jenneke, would have very serious consequences for Australia and global markets.

Companies are already responding by reducing inventories and capital expenditure plans, which leads to lower GDP and employment growth at a very inopportune time, given the global economy is much less robust than a year ago.

While T.Rowe believes the RBA and APRA have now removed tail risk from the housing market, it does not mean the housing market is set to take off again. Rather, Jenneke expects stabilisation in the second half of 2019 and some limited improvement in domestic growth.

T. Rowe's team sees markets behaving in "fits and spurts" for the rest of the year, such as was the case in December last year, which will provide the longer term investor with an opportunity to buy high quality defensive names.

Jenneke remains most optimistic about healthcare, where there is less threat of competition, more market share consolidation and more durable and stable business models. He also believes good opportunities remain in stocks exposed to the Chinese consumer, select multinational growth companies with big offshore operations, along with industrials and consumer staples.

T. Rowe leans towards companies with strong balance sheets, excellent profitability and strong earnings growth.

On the flipside, T. Rowe is reducing holdings of high-beta, economy-sensitive companies.

Bapcor Driving Growth Despite Soft Consumer

Bapcor is cementing its position in car parts and brokers are upbeat about the stock, despite the likelihood growth rates will now be less stellar.

-Increased private label penetration expected to assist margin expansion -Acknowledges scope for improved marketing of car parts brands -Kick-along expected from recent monetary/fiscal stimulus

By Eva Brocklehurst

A weak macro environment has beset car parts specialist Bapcor ((BAP)) but brokers remain upbeat about the ability of the business to generate attractive returns. Morgans suggests there is increased confidence in the company's capacity to grow, reflected in its geographical expansion and acquisitions.

Bapcor has conducted a tour across its trade, retail and specialist wholesale operations. UBS points out the complexity in supplying a broad range of products to trade customers, generally, and, hence, the difficulty in also replicating Bapcor's position in this area.

The broker considers the company's target of more than 35% privat -label penetration in trade, versus the current 24.7%, is achievable and reiterates a Buy rating. Morgans believes the increased private label penetration will assist margin expansion and Bapcor is a relative safe haven in a volatile retail sector.

There are complexities in running a large business with many brands amid the need to invest in digital and supply chain. Yet Morgans notes the company has reiterated its guidance several times in recent weeks and solid single-digit growth can be expected in FY20.

Morgans acknowledges the company's growth profile has slowed from lofty heights but the business retains a defensive basis. The main focus is balancing same-store sales growth/gross margin to optimise profit, Macquarie asserts, also noting the opportunities in private label, store roll-outs and category expansion.

The company has reported its commercial truck part acquisitions have performed well, with around 40 stores targeted against the current 14. Whilst Bapcor does not compete with original equipment manufacturers (OEM), it differentiates its offer by selling both OEM and aftermarket parts for all major Japanese commercial truck manufacturers.

Morgan Stanley points out the stock has de-rated by -25% amid competitive concerns and a soft consumer environment. Regardless, the broker finds the risk/reward compelling, given the ability to deploy capital either into organic roll-out or acquisitions that leverage existing distribution and infrastructure.

The company has acknowledged that there is scope for improvement in marketing. The retail network is expected to improve its promotions calendar and reduce the heavy reliance on catalogues while better exploiting advertising and digital opportunities. There is a lack of awareness in the wholesale business around the quality or value proposition of many of the brands in the portfolio, which the company will seek to address.

Bapcor has opened four Burson stores in Thailand as part of a joint venture and will open another two shortly and is encouraged by the early response. UBS notes by behaviour by mechanics needs to change in order to lift sales volumes and the initial stores will need several months of trading, along with a parts catalogue for customers, before the model can be finessed for further roll-out.

Macquarie and Morgan Stanley observes market dynamics are attractive in Thailand, a fragmented market which has no large-scale competition or relationships with workshops. The company expects Thailand could support a trade business that is 60-70% of the size of Australia. This could be significant, Morgan Stanley assesses.

Warehousing

The company will start to rationalise 18 warehouses across Australia with its latest warehouse management IT infrastructure. The first major new distribution centre in Victoria is expected to be operational late in FY21. Beyond that, the company will likely consolidate the Brisbane and Western Australian warehouses, with cost savings on offer similar to the $10m envisaged for Victoria.

Morgan Stanley believes there is scope for significant rationalisation of the current warehouses footprint with goods-to-person driving labour optimisation. A $50m capital expenditure investment is expected to yield a $10m efficiency benefit and an upfront -$10m reduction in inventory.

This implies a 25% return on the $40m in net investment in relation to Melbourne. The broker sees no reason why a similar strategy would not be successful for the Brisbane footprint.

Structural vs Cyclical

While recent weakness has had investors questioning whether structural factors are at play, Macquarie notes this is not dissimilar to the US in 2017. Comparables subsequently rebounded there and valuations re-rated strongly.

Macquarie calculates the de-rating of the stock has meant it trades at a -17% discount to peers and, while softer conditions are likely to persist, there is scope for improved demand from recent monetary/fiscal stimulus.

Structural issues that centre on Amazon, which announced a further push into the US aftermarket space, have also abated in the US. Macquarie notes Amazon's penetration has been limited to date, given challenges regarding inventory, distribution and service requirements.

Macquarie believes opportunities exist for aftermarket distributors to evolve their business models in response to changes in the automotive industry, but this is a slow development which provides ample capacity for a response.

The broker expects consolidation of independent workshop networks is likely over time and larger franchises are expected to prevail versus traditional mechanical shops, given the vehicle computerisation trend and resulting capital requirements.

In sum, Macquarie believes the recent softening in operating trends is cyclical while competitive dynamics in the industry are rational. Moreover, the US experience suggests a cyclical recovery is the near-term catalyst in Australia.

FNArena's database shows five Buy ratings. The consensus target is $6.86, signalling 15.1% upside to the last share price. Targets range from $6.31 (Morgans) to $7.60 (Morgan Stanley).

East Coast Infrastructure: Worst Boom Ever?

By Liam Donohue, principal and portfolio manager, Lennox Capital

East Coast Infrastructure – Worst Boom Ever?

It is no secret that Australia's engineering and contracting industry has been positioning for an infrastructure-led boom on the east coast. Expectations of billions of dollars in government-funded investment have driven excitement levels to fever pitch. Many listed companies have rolled out charts showing a mountain of work available (see Chart 1), with the peak still years away. If you believe what you read, one would assume company profits are booming. However, for the listed market at least, this is not the case.

Chart 1. Estimated Civil Infrastructure Spending to 2025

Source: CIMIC, 1H19 Results Presentation released 5 Feb 2019

The unfortunate reality of the so called 'east-coast infrastructure boom' is that issues such as increasing competition from offshore entrants willing to accept impossibly low margins, elevated tendering costs, disproportionate risk sharing and interpretative accounting standards have all conspired to see margins squeezed and profits suppressed.

This ultimately has led to significant earnings downgrades and, in some cases, businesses either being wound up or sold (see Table 1).

Table 1. Selected Listed Companies Recently Impacted by East Coast Infrastructure Market

Source: Factset

Chart 2 emphasises how equity investors are viewing those companies impacted by an underwhelming infrastructure market. The chart takes an equal-weighted composite share price of the seven listed companies noted in Table 1 and charts them over the 12 months to 31 May 2019. The aggregate move of this composite is around -40% while the Small Ordinaries benchmark is up modestly over this period. Importantly, the market is showing no signs of warming to this group of companies despite some relative value arguably beginning to emerge.

Chart 2. 'East Coast Infrastructure' composite versus the S&P/ASX Small Ordinaries

Issues impacting the east coast infrastructure market

Increased competition from offshore entrants

Numerous foreign-owned contractors have joined the fray in recent years, typically with strong balance sheets and, importantly, a lower cost of capital. This has led to projects being bid with much lower margins than has historically been the case.

Much of the east coast infrastructure work currently being tendered for comprises complex tunnelling and transport system upgrades which could prove challenging for offshore contractors with limited local experience. In our view, slim margins and challenging technical works do not bode well for profitable outcomes.

The bid process costs millions

According to Roads Australia, project bid costs typically sit at 1-2% of total project spend. This means that on a $1 billion project it could theoretically cost up to $20 million just to bid. Add to this that only 11% of winning bidders receive bid cost reimbursement (and typically 0% of losing bidders) and it becomes obvious how costly the exercise can be for all interested parties.

Government shifting the risk

Engineering consultancy and research firm, WT Partnership, states that in Australia the risk assessment onus typically sits with the contractor, with governments often having no obligation to participate in risk research. This is in contrast to parts of the US where risk assessment is a cooperative process. While contractors should rightly expect a risk exposure on work performed, we wonder whether one-sided risk is at odds with the 'spirit' of social infrastructure investment. Sydney's light rail is an example of a project crippled by this scenario.

Increased scrutiny on the recognition of revenue and the treatment of net tangible assets

A change in accounting standards has prevented contractors from using litigation claims as part of their net tangible asset calculation. This has increased stress on the often tight balance sheets of service companies that traditionally are not asset-backed. This is in addition to revenue recognition practices that seem to vary across the industry. Some listed companies have been scrutinised by parts of the investment community in recent months in relation to recognising questionable revenues, sometimes causing share prices to drop sharply.

Is value emerging in the west?

While we remain optimistic longer term, we believe it is too soon to buy into many of the businesses exposed to the east-coast infrastructure thematic. As outlined above, the structural issues within the industry are preventing firms from generating meaningful returns in relation to often-substantial risks.

One way we are happy to play the Australian contracting sector is as far away as you can get from the east coast – Australia's west coast. We see Western Australia as offering a more equitable contracting balance between those offering the work and those doing the work. As at March 2019 there was an estimated $113 billion worth of resource projects in the pipeline in WA, much of which have very similar characteristics to civil infrastructure projects.

Furthermore, the value of projects currently under construction or in the committed stage of development is an estimated $25 billion. From this, it is clear there is a material volume of infrastructure-style work available in the west, possibly providing more reasonable return metrics for contractors.

From a Lennox Capital Partners' perspective, this analysis reinforces a number of key issues in relation to smaller companies. Most importantly for us, and consistent with our prior thought piece 'It pays to invert', we truly believe that avoiding the underperforming parts of the small-cap market can be just as important as picking the winners.

We will continue to avoid businesses with direct exposure to the east coast infrastructure boom based on the view that the sector will continue to underwhelm for the immediate future. However we are hopeful that in the coming quarters or years we will see evidence of a turnaround in the contracting space.

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Technical limitations

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Material Matters: Iron Ore And Base Metals

A glance through the latest expert views and predictions about commodities. Iron ore and base metals.

-Record steel production in China and supply shortages continue to elevate iron ore -Will China's credit impulse drive a turnaround in metal prices? -JPMorgan expects copper surplus to return in 2020

By Eva Brocklehurst

Iron Ore

Chinese steel production was at another record in May while the output from the rest of the world was up just 0.3% year-on-year. JPMorgan notes shipments have recovered from Australia and Brazil and there has been an rise in domestic Chinese production, although port inventory is still shrinking. The broker upgrades iron ore prices (again) with 62% iron estimates up 13% and 18% for 2019 and 2020, respectively.

The broker has been surprised by the strength in iron ore, which rose to US$127/t in early July. The main triggers were lower Chinese port stocks and a potential ban on tailings dams in Brazil over the medium to longer term. The broker expects non-traditional supply re-starts and a seasonal downturn in Chinese demand will drive prices down in the second half.

Citi suspects a banning of all tailings dams in Brazil and the proposed Special Participation Tax are unlikely. The broker believes it more likely that royalties will be raised, as this may not substantially affect the planned output of iron ore.

Morgan Stanley suspects a boom-bust cycle could repeat in iron ore, noting the price tends to revert back to marginal cost within the year after the price rises or falls sufficiently to resolve market imbalances.

A drop in Chinese steel production can pull the iron ore price down very quickly. While current price movements are modest from an historical perspective, the broker assesses the cost curve has structurally changed, as low-cost supply from Australia and Brazil has driven out Chinese and Indian supply.

Morgan Stanley believes the market is currently in incentive territory with an incentive price of US$63/t for a selection of 127mtpa of unapproved projects at a 10% internal rate of return. However history suggests that new mines often start producing when the price has fallen. India could also be a key player in the seaborne market again, given its rising steel output.

While reiterating Outperform ratings, Macquarie switches preference to Rio Tinto ((RIO)) over BHP Group ((BHP)), given the former's greater exposure to the upgraded outlook for iron ore. Fortescue Metals ((FMG)) remains the preferred pink of the pure bulk miners and the broker is also positive about Champion Iron ((CIA)) and Mount Gibson ((MGX)).

Macquarie upgrades 2019 and 2020 forecasts for iron ore by 27% and 25% respectively, reflecting a combination of stronger Chinese steel production and ongoing supply shortages.

Base Metals

Citi expects metals particularly, and commodities generally, could obtain strong cyclical support in the northern autumn, were China to continue adding credit to the system at the current pace of growth. If the current pace of growth continues through to the end of 2019 the broker estimates the Chinese credit impulse could rise above 1.8 percentage points by September and to 4.0 percentage points by November.

In early 2016, such growth signalled a turn in metals. However, the broker assesses that in prior Chinese easing cycles, metals prices tended to grind lower until the credit impulse was large enough. Hence, the broker recommends waiting for Chinese credit data to improve further before buying the metals complex aggressively.

In base metals and alumina, Macquarie downgrades South32 ((S32)) to Underperform as cuts to forecasts translate to material reductions in the earnings outlook.

Alumina price forecasts are reduced by -9% for 2019 and -15% for 2020. As a result Macquarie downgrades earnings estimates for Alumina Ltd ((AWC)) and cuts the rating to Underperform. Sandfire Resources ((SFR)) is downgraded to Neutral as a result of material downgrades to the outlook for more leveraged stocks.

The broker retains a preference for OZ Minerals ((OZL)) and Independence Group ((IGO)) in the base metals space. The stocks offer positive organic catalysts, while having a higher exposure to gold than peers.

Although copper miners have underperformed the wider sector in the year to date, JPMorgan takes a cautious view on copper. Volatility is likely to be supported by the ongoing trade dispute between China and the US but a significant surplus is expected to return in 2020.

Significant supply additions are expected from smaller projects as well as from the Democratic Republic of the Congo and China. The latter two are regions where there is a lack of clarity on projects and this could means the market may underestimate the amount of supply.

JP Morgan also believes technological innovations could offer solutions to the challenges with water and tailings at mines in water-stressed areas such as Chile, Peru, Mexico in Australia, while also improving project economics. However, JPMorgan does not envisage water security impeding near-term growth in copper supply. The broker envisages an opportunity among inexpensive copper miners with strong balance sheets.

Citi is not convinced that high copper premiums in the US could be a signal for demand improvement. Freight is the dominant driver of the level of the US copper premium and freight costs have retreated from highs of 2018.

Material Matters: Oil, Gold, Iron Ore & Coal

A glance through the latest expert views and predictions about commodities. Oil; gold; iron ore; and coal.

-Supply concerns ease for oil while demand issues increase -Goldman Sachs finds gold stocks continue to offer value -Iron ore price, ultimately, likely to depend on Chinese steel production -Wilsons constructive on thermal coal for second half of 2019

By Eva Brocklehurst

Oil

Brent crude oil has recovered losses endured after the sell-off following the meeting of OPEC et al in early July and has moved above US$66/bbl. The seizure by Gibraltar's authorities of cargo loaded with Iranian crude, reportedly headed for Syria, has revived tensions with Iran.

Meanwhile, Citi notes a dovish stance appears to have been affirmed following the June US Fed meeting, supporting investor sentiment for risky assets and weakening the US dollar.

Further dovish policy from the European Central Bank is also considered likely as Christine Lagarde takes over from Mario Draghi.

Supply-side concerns have eased as OPEC has extended production cuts amid heightened geopolitical tensions. Instead, RBC Capital Markets points out concerns regarding demand have stepped up, amid fears of a trade war and persistently weak refining margins.

Given the relatively weak macro backdrop, the broker prefers stocks that are leveraged towards bankable resources. The broker favours Santos ((STO)) for its growth opportunities. Carnarvon Petroleum ((CVN)) is also a favourite in the small-cap coverage.

For east coast gas leverage RBC Capital Markets assesses Comet Ridge ((COI)) is well-placed for a period of performance reversion compared with Cooper Energy ((COE)) and Beach Energy ((BPT)), with development of the Mahalo project accelerating.

The broker also likes Australis Oil ((ATS)), with its recently-introduced water-based drill solution proving successful and boding well for the remainder of its campaign at Quin.

Credit Suisse modestly increases forecasts for oil, raising 2019 Brent estimates to US$68/bbl. Modest tightening of balances in the second half of the year, combined with elevated geopolitical risk, is expected to support prices.

Forecasts for 2020 are lowered slightly, to US$65/bbl, as inventory is expected to build on robust non-OPEC growth, such as US shale, Brazil and deepwater start-ups in Norway/Guyana.

The main upside risks are supply disruptions because of hostilities between Iran and the US, a sharp reduction decline in Libya or a slowdown in US production growth. The main downside risks for oil are envisaged to be a further slowing in global demand growth, larger-than-expected US production growth and an absence of OPEC discipline.

Gold

Goldman Sachs increases 2019 gold price forecasts by 3% to US$1384/oz and the long-run price to US$1400/oz. The broker believes gold continues to offer significant diversification value. Goldman Sachs notes OceanaGold ((OGC)) has not participated in the sector rally because of underperformance at Haile, permit issues and production interruptions in the Philippines.

However, the broker suggests production growth from Haile and the extension to mine life in New Zealand are under-appreciated. Along with updates to gold price forecasts, Goldman Sachs upgrades the stock to Buy from Neutral.

Resolute Mining ((RSG)), also upgraded to Buy, has obtained a key de-risking catalysts when achieving commercial production at Syama's sub-level cave. Production has been well supported by the strong performance of the Tabakaroni oxides.

In contrast, Newcrest Mining ((NCM)), which has been the best performer under the broker's coverage, is downgraded to Sell. Goldman Sachs expects Cadia production will drop by -15% in FY20 as grades decline and expenditure lifts.

Iron Ore

Credit Suisse notes the spot iron ore price fell -US$8/t last Friday amid reports that a meeting of eight steel mills in China had condemned speculation in the iron ore price and launched an investigation. The representative group, China's iron and steel industry association, lobbies government in the interests of its members, which comprise 98 medium and large steel mills that account for around 75% of China's steel production.

However, Credit Suisse suspects the group is powerless on its own. Port stocks are expected to lift slightly over the next couple of weeks after Australian shipments rose when miners raced to meet guidance in the last two weeks of June.

Ultimately, the broker expects port stocks and the iron ore price will depend on Chinese steel production. If steel output falls in the second half of the year then port stocks may start to rebuild in the fourth quarter and the price unwind.

Coal

Metallurgical (coking) coal outperformed expectations over the June quarter as Wilsons notes supply/demand was favourable and steel production underpinned prices. On the other hand, thermal (energy) coal prices retreated as Indonesian supply into the market.

Wilsons is somewhat constructive on thermal prices at this point in the year. Thermal prices are expected to rebound over the second half as summer energy peaks in Asia and Europe occur and the traditional inventory build commences.

Wilsons maintains Buy ratings for both Whitehaven Coal ((WHC)) and Stanmore Coal ((SMR)) and upgrades New Hope Corp ((NHC)) to Buy as the valuation is attractive and investors are buying a free option on Acland. The broker considers the recent correction in the market a solid entry point for investors, given the yield and value.

Thermal coal price forecasts are reduced to US$80/t for FY20 and metallurgical coal forecasts are raised to US$180/t. Overall, average FY20 prices are expected to moderate but the timing is considered likely to be very different for the two major coal sets.

ESG Focus: NSW Modern Slavery Act Postponed

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

The postponement of the NSW Modern Slavery Act provides a great platform to discuss one of the most emotive and interesting economic issues in environmental, social and governance investing today, and its ramifications for investors and corporations.

The commencement of the pecuniary NSW Modern Slavery Act has been delayed For now the Federal Slavery Act will be the guide for business, taking a softly-softly approach, but enforcement is likely to rise Australian legislative changes are part of a global movement By Sarah Mills

Businesses are no doubt breathing a collective sigh of relief after news the NSW Modern Slavery Act, which was due to commence in July, was postponed indefinitely, and may be repealed.

The Act, which was due to start on July 1, requires businesses with a consolidated revenue of $50m or more to make a statement to government describing the risks of modern slavery in its supply chains. Failure to comply would have exacted a $1m fine.

The Act also calls for a modern slavery commissioner. These are all commendable actions but their implementation at this point is impractical, hence, no doubt, the postponement of the legislation.

But businesses are not entirely off the hook as the much less burdensome Federal Modern Slavery Act came into effect in January. It is this statute that will likely set the tone for corporations for the next two years.

Under the legislation, any organisation conducting business in Australia with a minimum annual consolidated revenue of $100m will have to make a statement to government describing the risks of modern slavery in its supply chains. The legislation proposes no fines and no enforcer.

History and economics of slavery

Since William Wilberforce campaigned for the abolition of slavery in Britain and President Lincoln led the Union to victory in the American Civil War, slavery has been a defining issue for Western democracies and religions.

But it has also had a significant, less widely broadcast economic component. In the 1800s, the southern states of America with their well-organised, entrenched system of black slavery, had a significant competitive agricultural advantage over the free states of the north.

It was during this period that the American banking system, national currency, northern manufacturing base and income tax were established in the Union states. It was as much the economic buy-in of wealthy northern businessman and legislators, as well as the buy-in from Puritan Christian groups to supply their sons for the crusade, that turned the tide of American history.

Similarly, in Britain, the practices of unscrupulous slave traders and shippers were soon bleeding through to the pockets of other organisations, such as insurers, garnering support from various business interests for Wilberforce's campaign in an industrialising Christian Britain.

It also bled into international relations, as African slave uprisings defeated Britain in the Caribbean. Slavery practices, while profitable for slave traders and many slave owners, often had unintended consequences for broader economies, both good and bad, as argued in an article by The Economist titled 'Did Slavery Make Economic Sense?'.

While the face of slavery has altered dramatically since the 1800s, the fundamental social and economic dynamics remain very much the same. Not only does it muddy the competitive waters, it skews global trade relations, potentially stymies innovation, and can increasingly trigger reputational and financial damage for global corporations and sovereign nations – not to mention the devastating impact on individuals.

In the past 40 years since the fall of the Berlin Wall and the collapse of communism in the Soviet Union, the mobilisation and globalisation of capital and labour with its accompanying focus on short-term profit, has resulted in slavery becoming a prominent, if less visible, component of western economies. Slavery has infiltrated nearly every supply chain in the world.

According to the Walk Free Foundation’s Global Slavery Index, as at September 2017, US$150bn was generated in the global private economy from forced labour alone, let alone from the broader spectrum of slavery as defined under the Modern Slavery Act.

One in 200 people are slaves. Roughly two thirds of human trafficking in the United States and Europe is of its own citizens.

Modern slavery is an umbrella term for crimes that include slavery, servitude, serious child labour, forced labour, human trafficking, debt bondage, slavery like practices, forced marriage, removal of organs and other slavery like practices.

As we shift to an age of enforcement, moves are afoot to deal with the problem, not just as a moral issue, but as a point of ensuring social stability and economic security.

The United Nations Guiding Principles (UNGP) on businesses and human rights have been developed to guide mutli-nationals on the issue of slavery. It evolved from early attempts at codes of conducts in the 1970s, to debates around the turn of the century regarding business responsibility for slavery and business rights, to its final iteration in 2011.

It is these 31 principles against which most ESG investing is benchmarked. The key onus of businesses is to display due diligence in this arena and the UNGP represents, at this stage, a soft law approach.

Sustainable Development Goals

In terms of the United Nation’s Sustainable Development Goals (SDG), slavery falls under:

SDG 5.2: Eliminate all forms of violence against all women and girls in public and private spheres, including trafficking and sexual and other types of exploitation; SDG 8.7: Take immediate and effective measures to eradicate forced labour, end modern slavvery and human trafficking, and secure the prohibition and elimination of the worst forms of child labour, including recruitment and use of child soldiers, and by 2025 end child labour in all its forms. SDG 16.2: End abuse, exploitation, trafficking and all forms of violence against and torture of children. To continue with Part Two.

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

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

Weekly Ratings, Targets, Forecast Changes

By Rudi Filapek-Vandyck, Editor FNArena

Guide:

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

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

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

Summary

Period: Monday July 1 to Friday July 5, 2019 Total Upgrades: 5 Total Downgrades: 10 Net Ratings Breakdown: Buy 39.23%; Hold 44.67%; Sell 16.10%

It is quiet in the land of stockbroking analyst where attention is increasingly shifting towards the upcoming August reporting season.

With the local share market moving ever higher, destined to revisit the all-time high from 2007, it is no surprise that when it comes to recommendations for individual ASX-listed entities, the balance remains heavily weighted towards downgrades.

For the week ending Friday, 5th July 2019, FNArena registered five upgrades, of which only two moved to Buy, and ten downgrades. Only three of the downgrades moved to Sell with Independence Group, Origin Energy and Netwealth the unlucky receivers. Independence Group also received a second downgrade which ended on Neutral.

Most cited reason for the downgrade is a share price that looks too expensive with what is likely to follow next in terms of growth outlook.

It's eerily quiet in the section dedicated to share price targets. Both positive and negative amendments have only two changes worth mentioning; Growthpoint Properties and Mirvac Group on the plus side, and New Hope Corp and Netwealth on the minus side of the week's ledger.

The view is hardly different when we zoom in on earnings forecast changes. Apart from Perseus Mining, Insurance Australia Group and Independence Group there is not much to report in terms of positive changes. The negative side has Galaxy Resources, Graincorp, Superloop and Japara Healthcare standing above the crowd.

Economic data and expectations of central bank rate cuts continue to dominate equity markets globally. The focus might switch to corporate profits soon with the Q2 season about to start in the US and with Australia less than one month away from its own corporate reporting season.

Upgrade

AGL ENERGY LIMITED ((AGL)) Upgrade to Neutral from Underperform by Credit Suisse .B/H/S: 0/5/3

Credit Suisse expects the company's retail gross margins to bottom in FY20 and net margins to bottom in FY19. AGL Energy is expected to report FY19 net profit of $1.01bn, just below the mid point of guidance.

The broker upgrades to Neutral from Underperform as the stock has underperformed its historical correlation to bonds and utility peers. Target is raised to $19.20 from $18.30.

NEW HOPE CORPORATION LIMITED ((NHC)) Upgrade to Add from Hold by Morgans .B/H/S: 2/1/0

Morgans observes sharply weaker seaborne thermal coal prices have contributed to a correction in the stock of almost -40%, attributing the weakness to tepid demand, poor producer discipline and some fuel switching into LNG.

The broker believes, while the stock may temporarily be in the "too hard basket", significant value is on offer. The broker considers the market value ignores the non-cash producing assets and the potential recovery in the coal price.

Rating is upgraded to Add from Hold. Target is reduced to $3.37 from $3.80.

ORIGIN ENERGY LIMITED ((ORG)) Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 5/3/0

Credit Suisse upgrades to Outperform from Neutral as the stock has underperformed electricity and Brent futures as well as its peers in energy. Margins are expected to bottom in FY20.

The broker expects a strong result, at the top end of guidance, when Origin Energy reports on August 22. Target is increased to $8.50 from $7.55.

PILBARA MINERALS LIMITED ((PLS)) Upgrade to Hold from Lighten by Ord Minnett .B/H/S: 2/1/0

Ord Minnett updates commodity price forecasts, skewing its preferences towards bulk commodities and gold. Downgrades of -5-7% occur across base metals.

The broker notes iron ore prices hit 2019 peak this week, pushing over US$125/t amid ongoing reductions in China's port stocks and strength in Chinese demand.

Rating is upgraded to Hold from Lighten. Target is reduced to $0.60 from $0.65.

SPEEDCAST INTERNATIONAL LIMITED ((SDA)) Upgrade to Neutral from Underperform by Macquarie .B/H/S: 0/3/0

Operational issues continue to dog SpeedCast, as evidenced by a -12% earnings guidance downgrade for FY19. Leverage is now an issue, with debt covenants at risk, Macquarie notes.

There is thus a risk an equity raising will be required, however there is also a chance SpeedCast could now be itself corporate target having made over 15 acquisitions since 2012. It would depend on whether another player is prepared to take on the debt, but given SpeedCast's lower valuation, Macquarie upgrades to Neutral.

Target falls to $2.25 from $2.85.

Downgrade

INSURANCE AUSTRALIA GROUP LIMITED ((IAG)) Downgrade to Equal-weight from Overweight by Morgan Stanley .B/H/S: 2/5/1

Morgan Stanley believes the investment case is robust, with cost reductions and capital initiatives, but there is a risk of a rising catastrophe budget amid lower yields and elevated compliance costs. This is likely to contribute to softer FY20 guidance.

The broker downgrades to Equal-weight from Overweight. Target is reduced to $8.20 from $8.50. Industry view: In Line.

INDEPENDENCE GROUP NL ((IGO)) Downgrade to Hold from Accumulate by Ord Minnett and Downgrade to Underperform from Neutral by Credit Suisse .B/H/S: 3/3/1

Ord Minnett updates commodity price forecasts, skewing its preferences towards bulk commodities and gold. Downgrades of -5-7% occur across base metals.

Rating on Independence Group is downgraded to Hold from Accumulate. Target is steady at $5.30.

Credit Suisse finds the environment for base metal demand challenging, given US/China tensions and tariffs elsewhere, as well as the deterioration in global economic conditions.

The broker downwardly revises estimates for nickel, alumina and aluminium and only lifts copper forecasts, largely because of supply factors.

Independence Group is downgraded to Underperform from Neutral while the target is reduced to $4.00 from $4.10.

ILUKA RESOURCES LIMITED ((ILU)) Downgrade to Hold from Accumulate by Ord Minnett .B/H/S: 3/3/0

Ord Minnett updates commodity price forecasts, skewing its preferences towards bulk commodities and gold. The broker downgrades its rating on Iluka Resources to Hold from Accumulate and raises the target to $10.75 from $10.50.

MONADELPHOUS GROUP LIMITED ((MND)) Downgrade to Neutral from Buy by UBS .B/H/S: 0/4/1

UBS updates its database for iron ore capital expenditure, now estimating total investment in Western Australia could be around US$21bn. This expenditure is expected to be delivered through FY19-22.

The broker downgrades Monadelphous to Neutral from Buy on valuation grounds as the share price has increased around 40% over the past 12 months. Target is steady at $19.

The broker also updates FY21/22 forecasts for earnings per share, reducing FY21 by -10% and increasing FY22 by 5%, while re-profiling iron ore construction forecasts, given increased visibility.

NETWEALTH GROUP LIMITED ((NWL)) Downgrade to Underperform from Neutral by Macquarie .B/H/S: 1/3/2

Macquarie notes that if yesterday's RBA rate cut is fully passed on to cash allocations in portfolios on Netwealth's platform, the return on cash will be 50 basis points. Add in the -59 basis point admin fee, and returns are now negative.

The broker also notes the UK market presents downside risk to margins for both Hub24 and Netwealth. On increasing margin compression risk, the broker lowers its target for Netwealth to $6.05 from $7.83. Downgrade to Underperform.

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

Credit Suisse increases gold price forecasts, given the recent momentum based on a confluence of supportive macro economic and geopolitical factors.

The broker now estimates gold to average US$1327/oz in 2019, rising to US$1350/oz in 2020. The broker downgrades Perseus Mining to Neutral from Outperform and raises the target to $0.59 from $0.57.

RAMSAY HEALTH CARE LIMITED ((RHC)) Downgrade to Hold from Accumulate by Ord Minnett .B/H/S: 1/6/1

Ord Minnett is comfortable with expectations for mid single-digit growth from the Australian operations, to be boosted over the next couple of years by the acquisition of Capio.

However, forecast for FY19 and FY20 are lowered following a review of the expected timing and interest costs arising from the Capio acquisition.

Rating is downgraded to Hold from Accumulate and the target is steady at $75. Revised earnings forecasts imply 7% growth in earnings per share in FY20 and FY21, driven by the domestic business.

SUNCORP GROUP LIMITED ((SUN)) Downgrade to Underweight from Equal-weight by Morgan Stanley .B/H/S: 4/2/2

Morgan Stanley expects the second half will show the company is struggling to maintain volumes in personal lines.

Guidance is expected to disappoint, as Suncorp balances growth campaigns alongside the need to price for a higher FY20 catastrophe budgets, amid the impact of lower yields

Rating is downgraded to Underweight from Equal-weight. Target is reduced to $11.90 from $12.50. In-Line sector view.

TELSTRA CORPORATION LIMITED ((TLS)) Downgrade to Neutral from Buy by UBS .B/H/S: 2/4/2

UBS assesses investors are pricing in a future improvement in mobile earnings. The stock may continue to outperform, the broker acknowledges, on relative yield in a low-interest rate environment.

However the metrics for mobile in the short-term still reflect the destructive pricing in the industry experienced until early 2019.

UBS lifts the target to $4.00 from $3.60 and downgrades to Neutral from Buy as the stock appears fairly valued.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 AGL ENERGY LIMITED Neutral Sell Credit Suisse 2 NEW HOPE CORPORATION LIMITED Buy Neutral Morgans 3 ORIGIN ENERGY LIMITED Buy Neutral Credit Suisse 4 PILBARA MINERALS LIMITED Neutral Sell Ord Minnett 5 SPEEDCAST INTERNATIONAL LIMITED Neutral Sell Macquarie Downgrade 6 ILUKA RESOURCES LIMITED Neutral Buy Ord Minnett 7 INDEPENDENCE GROUP NL Sell Neutral Credit Suisse 8 INDEPENDENCE GROUP NL Neutral Buy Ord Minnett 9 INSURANCE AUSTRALIA GROUP LIMITED Neutral Buy Morgan Stanley 10 MONADELPHOUS GROUP LIMITED Neutral Buy UBS 11 NETWEALTH GROUP LIMITED Sell Neutral Macquarie 12 PERSEUS MINING LIMITED Neutral Buy Credit Suisse 13 RAMSAY HEALTH CARE LIMITED Neutral Buy Ord Minnett 14 SUNCORP GROUP LIMITED Sell Neutral Morgan Stanley 15 TELSTRA CORPORATION LIMITED Neutral Buy UBS Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 NHC NEW HOPE CORPORATION LIMITED 67.0% 33.0% 34.0% 3 2 GOZ GROWTHPOINT PROPERTIES

AUSTRALIA -33.0% -67.0% 34.0% 3 3 MGR MIRVAC GROUP -8.0% -30.0% 22.0% 6 4 PGH PACT GROUP HOLDINGS LTD 40.0% 20.0% 20.0% 5 5 GXY GALAXY RESOURCES LIMITED 58.0% 40.0% 18.0% 6 6 PLS PILBARA MINERALS LIMITED 67.0% 50.0% 17.0% 3 7 ORG ORIGIN ENERGY LIMITED 63.0% 50.0% 13.0% 8 8 AGL AGL ENERGY LIMITED -38.0% -50.0% 12.0% 8 9 VOC VOCUS GROUP LIMITED 25.0% 14.0% 11.0% 8 10 GPT GPT -17.0% -20.0% 3.0% 6 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 PRU PERSEUS MINING LIMITED 67.0% 100.0% -33.0% 3 2 IGO INDEPENDENCE GROUP NL 29.0% 50.0% -21.0% 7 3 REA REA GROUP LIMITED 31.0% 50.0% -19.0% 8 4 MND MONADELPHOUS GROUP LIMITED -25.0% -8.0% -17.0% 6 5 NWL NETWEALTH GROUP LIMITED -25.0% -8.0% -17.0% 6 6 IAG INSURANCE AUSTRALIA GROUP LIMITED 6.0% 19.0% -13.0% 8 7 SUN SUNCORP GROUP LIMITED 25.0% 38.0% -13.0% 8 8 DHG DOMAIN HOLDINGS AUSTRALIA LIMITED -25.0% -14.0% -11.0% 8 9 ILU ILUKA RESOURCES LIMITED 50.0% 58.0% -8.0% 6 10 GNC GRAINCORP LIMITED 67.0% 75.0% -8.0% 3 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 GOZ GROWTHPOINT PROPERTIES AUSTRALIA 3.847 3.667 4.91% 3 2 MGR MIRVAC GROUP 2.895 2.782 4.06% 6 3 ORG ORIGIN ENERGY LIMITED 8.206 8.088 1.46% 8 4 GNC GRAINCORP LIMITED 9.590 9.453 1.45% 3 5 IGO INDEPENDENCE GROUP NL 4.921 4.864 1.17% 7 6 PRU PERSEUS MINING LIMITED 0.647 0.640 1.09% 3 7 PGH PACT GROUP HOLDINGS LTD 3.266 3.236 0.93% 5 8 AGL AGL ENERGY LIMITED 19.280 19.168 0.58% 8 9 ILU ILUKA RESOURCES LIMITED 10.833 10.792 0.38% 6 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 NHC NEW HOPE CORPORATION LIMITED 3.123 3.267 -4.41% 3 2 NWL NETWEALTH GROUP LIMITED 8.097 8.435 -4.01% 6 3 PLS PILBARA MINERALS LIMITED 0.883 0.900 -1.89% 3 4 VOC VOCUS GROUP LIMITED 3.666 3.734 -1.82% 8 5 GXY GALAXY RESOURCES LIMITED 2.142 2.170 -1.29% 6 6 SUN SUNCORP GROUP LIMITED 13.863 13.994 -0.94% 8 7 REA REA GROUP LIMITED 87.630 88.291 -0.75% 8 8 NCM NEWCREST MINING LIMITED 24.430 24.501 -0.29% 7 9 IAG INSURANCE AUSTRALIA GROUP LIMITED 7.741 7.760 -0.24% 8 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 PRU PERSEUS MINING LIMITED 1.433 -4.233 133.85% 3 2 IAG INSURANCE AUSTRALIA GROUP LIMITED 41.571 39.586 5.01% 8 3 IGO INDEPENDENCE GROUP NL 13.150 12.568 4.63% 7 4 CHC CHARTER HALL GROUP 44.540 43.900 1.46% 4 5 SUN SUNCORP GROUP LIMITED 74.643 73.571 1.46% 8 6 PGH PACT GROUP HOLDINGS LTD -8.215 -8.315 1.20% 5 7 GOZ GROWTHPOINT PROPERTIES AUSTRALIA 23.133 22.900 1.02% 3 8 FMG FORTESCUE METALS GROUP LTD 114.330 113.235 0.97% 8 9 NST NORTHERN STAR RESOURCES LTD 36.570 36.233 0.93% 7 10 EVN EVOLUTION MINING LIMITED 13.206 13.137 0.53% 8 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 GXY GALAXY RESOURCES LIMITED -1.623 -0.629 -158.03% 6 2 GNC GRAINCORP LIMITED -20.633 -12.690 -62.59% 3 3 SLC SUPERLOOP LIMITED -5.650 -4.450 -26.97% 3 4 JHC JAPARA HEALTHCARE LIMITED 6.550 6.800 -3.68% 4 5 NHC NEW HOPE CORPORATION LIMITED 43.517 44.383 -1.95% 3 6 CSR CSR LIMITED 29.812 30.163 -1.16% 7 7 S32 SOUTH32 LIMITED 31.430 31.787 -1.12% 8 8 QBE QBE INSURANCE GROUP LIMITED 88.017 88.944 -1.04% 8 9 CGF CHALLENGER LIMITED 50.029 50.457 -0.85% 8 10 WOR WORLEYPARSONS LIMITED 59.003 59.503 -0.84% 7 Technical limitations

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

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The Short Report

Guide:

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

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

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

Summary:

Week ending July 4, 2019

Last week saw the ASX200 enjoy another rate cut and push towards a new post-GFC high.

Perhaps the most interesting thing to note about the table below is that there wasn't a lot of short position movement last week but the number of stocks holding short positions of 5% or more is quietly shrinking. Presumably that is reflective of the determined push to a new all-time high for the index.

Not shrinking, however, is the 10% plus shorted club. Of the 45 stocks in total shorted by 5% or more, 29% are shorted by 10% or more. This would reflect stock-specific rather than market-specific views.

Two stocks saw short position movements of one percentage point or more last week. One was Bellamy's ((BAL)), up to 15.2% from 14.2%, but such moves this high up in the table are common and not worth dissecting unless something obvious has occurred.

The other was SpeedCast International ((SDA)), which I flagged last week was a good chance to see some short-covering after the stock fell -56% following a profit warning. SpeedCast shorts have fallen to 7.9% from 9.9%.

Otherwise, my only other "keep an eye on" stock, which I have highlighted before as making a steady climb up the table, is investment platform Hub24 ((HUB)). As debate rages among analysts as to whether RBA rate cuts will force Hub and peers to cut margins (Hub says no), shorts have ticked up further to 9.4% from 8.6%.

No Movers & Shakers this week.

Weekly short positions as a percentage of market cap:

10%+ SYR 18.7 NUF 17.5 ING 16.2 BAL 15.2 ORE 14.9 NXT 14.6 GXY 14.1 JBH 13.4 BWX 12.6 DMP 11.1 BIN 10.8 PLS 10.7 MTS 10.2

No changes

9.0-9.9

BGA, HVN, HUB, SGM, RWC

In: HUB, RWC Out: SDA, IFL 8.0-8.9%

IFL, IVC, PPT, CGC, CSR, BKL

In: IFL , SUL Out: HUB, RWC

7.0-7.9%

SDA, KGN, SUL, AMP, BOQ, DCN, MYR, CGF

In: SDA, SUL, MYR, CGF

6.0-6.9%

WSA, A2M, NEC, ELD, GMA, GWA

In: GWA

5.0-5.9%

MSB, COE, SXY, LNG, CTD, CLQ

Out: GWA, RSG, OML

Movers & Shakers

See above.

ASX20 Short Positions (%)

Code Last Week Week Before Code Last Week Week Before AMC 1.8 1.7 RIO 4.5 4.6 ANZ 0.5 0.7 S32 0.8 0.8 BHP 2.9 3.0 SCP 0.9 1.2 BXB 0.2 0.3 SUN 0.4 0.5 CBA 1.1 1.2 TCL 0.7 0.8 COL 1.4 1.4 TLS 0.4 0.5 CSL 0.4 0.4 WBC 1.3 1.4 IAG 0.7 0.7 WES 1.5 1.6 MQG 0.9 0.9 WOW 1.5 1.7 NAB 0.5 1.2 WPL 0.7 0.7 To see the full Short Report, please go to this link

IMPORTANT INFORMATION ABOUT THIS REPORT

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

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

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

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

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

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

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

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

The Wrap: Services, Retail And Online Ads

Weekly Broker Wrap: service exports; supermarkets; retail; and online classifieds.

-Softer near-term outlook for Chinese tourism and education exports -Coles strategy resonating with suppliers, UBS notes culture improving -Better outlook for discretionary retailing -Real estate listings, job advertising volumes remain weak

By Eva Brocklehurst

Service Exports

Australia's service exports have primarily centred on tourism and education and are currently worth around $8bn per month. While China has become the strongest contributor to visitor and student numbers coming to Australia, ANZ economists note growth has slowed rapidly.

The economists suspect the trade dispute with the US, and resultant political uncertainty, has contributed to the decline. The softness is expected to continue into 2020 when the trade dispute is likely to be resolved.

Despite this, there remains potential in the education and tourism sectors. China's middle-class is estimated to increase by another 370m people by 2030. While this should allow strong growth in tourism to Australia to return, there is not quite as much scope for growth in education.

As China continues to develop, its universities will also increase in quality and reputation. Once this happens fewer students will choose to travel overseas.

Supermarkets

UBS has explored the strategic and tactical as well as cultural aspects of supermarket operations in its latest survey. The new strategy from Coles ((COL)) is resonating with suppliers and the culture looks to be improving, although there were no improvements in customer-facing drivers.

Meanwhile, supplier tensions are building for Woolworths ((WOW)) because of negative culture and relationship scores. Inflation is returning which is a positive for market growth and UBS believes Woolworths is executing best in this regard, although it needs to re-engage with suppliers or risk support moving away to its competitors.

Retail

Weakness in retail sales was broad-based in May, UBS notes, dragged down by food, household goods and apparel. Stimulus over the next 6-12 months should provide some impetus but the broker remains cautious about retailers directly exposed to housing such as JB Hi-Fi ((JBH)) and Harvey Norman ((HVN)). The broker prefers Flight Centre ((FLT)), Treasury Wine Estates ((TWE)), Bapcor ((BAP)) and Viva Energy ((VEA)).

Citi considers the outlook favourable for discretionary retailing in FY20, for the first time since FY16. The basis for the broker's optimism relates to a combination of tax cuts, official interest rate reductions, falling living costs and a stabilising housing market. The broker has upgraded Flight Centre to Buy and JB Hi-Fi, Harvey Norman and Premier Investments ((PMV)) to Neutral, in taking a more positive stance on discretionary retail stocks.

The broker considers the balance of risks are to the downside for earnings and trading updates in the reporting season, creating a buying opportunity ahead of a more favourable retail backdrop. Despite the better sales background, margin pressure is expected to continue for some retailers.

This is resulting from higher wage costs, currency headwinds and a shift to the margin-dilutive online channel. Margins are expected to narrow, for JB Hi-Fi, Harvey Norman, Super Retail ((SUL)) and Myer ((MYR)). However, the broker has moderated the margin risk from the direct disruption by Amazon, pushing this out until FY24.

Online Classifieds

The decline in new listings for REA Group ((REA)) accelerated into the end of the year, UBS notes. While risks to FY20 estimates exist, the broker retains unchanged forecasts. Industry feedback suggests spring, i.e. August/September, will be the period to gauge any potential rebound.

History has shown that once a glut in listings starts to clear, usually accompanied by a stabilisation of prices, this can be a precursor to a rebound. There are risks that the structural elements make this cycle different, such as credit constraints and higher transaction costs, or that the recovery is delayed and/or less pronounced.

JPMorgan notes the fall in real estate listings of -24.8% for the week ended July 7 is worse than the average decline over the 21 prior weeks, and worse than declines currently estimated for both REA Group and Domain Holdings ((DHG)) in the second half.

UBS notes ANZ job advertising volumes remain weak, down -9% year-on-year in June, which takes the second half volume decline to around -7%. The broker suspects Seek's ((SEK)) reported job advertising volumes could decline in the low to mid single digits in the second half.

JPMorgan points out job listings at LinkedIn, as a percentage of Seek, decreased to 113.2% in the latest week versus 123.1% in the prior week. Total listings at Carsales.com ((CAR)) were down -9.6% in the latest reporting week and have averaged a fall of -7.9% in the year to date.

Divestment Lauded As EclipX Reduces Risk

Brokers welcome the prompt sale of two non-core businesses and the reduced risk of EclipX breaching its corporate debt covenants.

-Good first test of the credibility of new management -Right2Drive vehicle leasing remains the largest division to be divested -Upside now considered outweighing the downside

By Eva Brocklehurst

Vehicle leasing and salary packaging specialist EclipX ((ECX)) has been prompt in finding a buyer for its GraysOnline and AreYouSelling businesses, consequently reducing the risk of breaching its corporate debt covenants. Risks remain elevated but brokers consider these more manageable now.

The sale attracted a combined value of $60m and will generate a non-cash loss of -$100m. Proceeds will be applied to reducing corporate debt and lenders have agreed to remove the non-cash loss from covenant testing. The price received exceeded the amount allowed for the businesses, and Credit Suisse believes this provides a good first test of the credibility of new management.

There are several more catalysts for the near term, ahead of the results in November, which include the refinancing of corporate debt, further non-core asset sales and more cost cutting. The company will likely wear some stranded costs as more businesses are exited.

UBS believes the stock is attractively valued, estimating core net profit of $47-57m in FY19-20. As sector consolidation continues to be a feature, the broker assesses there are around $20-40m in synergies available in such a scenario.

Positive Step

The sale is a positive first step towards a renewed focus on the core business, Morgan Stanley asserts. Other non-core assets include commercial equipment, CarLoans and Right2Drive. GraysOnline, at $40-60m, made up the majority of the broker's valuation of $90-130m for non-core units.

Right2Drive is the largest of the remaining businesses to be divested. Citi points out Right2Drive and Onyx in this division were bought for $67m and $10m, respectively, but have since had their goodwill fully written down.

Despite lower values being realised for the latest sales, the broker points out that in the past, other companies have been awarded for increasing the focus on their core, including GUD Holdings ((GUD)), which disposed of Dexion, Oates and Sunbeam, and GWA Group ((GWA)), which sold Gliderol and Brivis.

Ideally, Right2Drive should now be disposed of prior to the end of the company's financial year in September. Credit Suisse, in holding this view, notes macro economic conditions remain subdued and end-of-lease income trends are negative.

Still, the broker considers the upside is outweighing the downside at the current valuation. Upgrades to estimates stem from cash flow and balance sheet revisions as a greater reduction in corporate debt is factored in.

FNArena's database shows four Buy ratings and one Hold (Morgan Stanley). The consensus target is $1.57, suggesting 4.7% upside to last share price. This compares with $1.44 ahead of the divestment announcement.Targets range from $1.29 (Citi) to $1.80 (UBS).

See also, Glimmer Of Light Visible For EclipX on June 4 2019

Disclaimer: the writer has shares in the stock.

Accelerating Repair Costs Benefit AMA Group

AMA Group stands to benefit substantially from the trends in vehicle repairs. Moelis initiates coverage of the stock.

-Scale benefits will allow significant investment in tooling and training -Main challenge is to avoid margin erosion -Substantial acquisition pipeline

By Eva Brocklehurst

Motor vehicle complexity is accelerating the cost of repairs and shifting the focus of the panel beating industry to parts replacement rather than labour-intensive repair. Panel repair and automotive accessories business, AMA Group ((AMA)), stands to benefit substantially.

Moreover, insurance industry data shows an increase in claims in the past two quarters. Accident frequency rates may be declining but the complexity of repairs, because of the technology involved as well as the materials used, is driving up the cost of claims.

Insurers faced with rising costs of claims are increasingly combining with a preferred repairer to improve claim experience and customer retention. Moelis believes, in order to improve productivity and maintain cost competitiveness, repairers will need to scale up and invest in technology and training.

AMA Group has the scale that allows significant investment in tooling, training and data systems to keep up with the growing complexity of electronic content and materials composition.

This trend will underpin the better capitalised operators, that are likely to consolidate the smaller businesses unable to respond to changes. In this regard, increased acquisition activity by AMA Group has led Wilsons to upgrade forecasts for outer years. Trading conditions appear consistent with expectations at this stage.

Accelerating Insurance Costs

Wilsons points out accelerating growth in average insurance claim values, reflecting the increasing vehicle complexity, is driving structural cost inflation in spare parts. AMA Group has a strong relationship with key insurers which brokers expect will ensure stability of turnover and underpin its investment in new capacity.

Moelis forecasts strong growth in earnings per share, averaging 23% over the next three years, underpinned by acquisitions as well as greenfield expansion, and initiates coverage with a Buy rating and target of $1.61.

The challenge will be for the company to negotiate contract pricing adjustments with insurer customers to avoid margin erosion, Wilsons assesses, maintaining a target of $1.08 and a Hold rating.

Moelis assumes margin pressure will continue in FY19 and FY20, because of the impact of the changing repair cost profile in the panels business. This should be offset in FY21 from updated agreements and predictive cost models which reflect the changing repair cost profile.

The benefits from centralised administration and national quoting should also materialise. The broker estimates FY20 normalised operating earnings (EBITDA) of $70.3m and $86.9m in FY21.

Acquisitions

The company entered the heavy vehicle truck market earlier this year with seven heavy vehicle panel shops and Wilsons expects it to be a bidder for SunCorp's Capital SMART business. UBS has pointed out the company has a substantial acquisition pipeline and considers the valuation undemanding, retaining a Buy rating and $1.35 target.

AMA Group is the largest smash repairer in Australia with 118 shops. It also provides automotive components and accessories. Smash repairs comprises 84% of the Moelis FY19 revenue estimate of $641m. The company is also in the process of expanding into procurement where it will provide consumables, paint and parts for external panel beaters and a positive contribution is expected in FY20.

See also AMA Group Zooms In On Acquisitions on March 5, 2019.

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

Treasure Chest: CC Amatil Lacks Fizz

FNArena's Treasure Chest reports on money making ideas from stockbrokers and other experts. Subdued volume growth in Australian supermarkets persists for Coca-Cola Amatil. Brokers are of the view that valuation is stretched.

-Goldman Sachs concerned about sustainability of margins -Investment in sales personnel to drive revenue in 2020 -A value-accretive acquisition could make a difference

By Eva Brocklehurst

Coca-Cola bottler Coca-Cola Amatil ((CCL)) has failed to impress brokers over recent months, despite managing costs well against reduced revenue growth.

Volumes remain subdued in Australian supermarkets, which brokers acknowledge may have been caused by the Queensland and NSW container deposit imposts, as well as a lack of consumer confidence surrounding the federal election. The implementation of a container deposit scheme in Western Australia next year, while unlikely to be material, could also be drag, Macquarie adds.

Australian earnings (EBIT) margins have declined since 2011. 2017 and 2018 margins included underlying cost savings of $45m and $35m, respectively, Goldman Sachs observes, and remains concerned about the sustainability of these margins in the absence of any further cost saving initiatives or a recovery in sales growth.

The broker acknowledges the success in New Zealand of creating more sales personnel to cater for the convenience channel, but there are notable differences between the company's market position in Australia versus New Zealand which may limit the potential. Compared with New Zealand there are a number of large, low-growth categories in Australia where Coca-Cola Amatil is under-represented, such as juice, dairy and alcohol.

Water and energy drinks remain high-growth categories in Australia but the company's 20-25% volume share is below its NZ category share. Bottlers are diversifying beyond carbonated soft drinks and Goldman Sachs believes the energy category presents an opportunity. Dairy is also a category where the company is attempting to improve penetration, leveraging the recently-acquired Rockeby Farms and the launch of Nutriboost.

Cost reductions have stemmed earnings declines during periods of weak revenue growth in recent years, Goldman Sachs notes, and the business is now relying on improved sales trends. Still the broker is cautious about the near-term growth potential. UBS assesses, on current trading, growth in mid single digits in 2020 and beyond is reasonable, noting 2019 is the second year of a two-year transition.

SPC

The company has completed the sale of the SPC fruit and vegetable processing, now enabling a focus on the core business. Given Coca-Cola Amatil had effectively written down the value to zero the expected profit on the sale of $10-15m was better than Deutsche Bank expected.

Indonesia

The company achieved double-digit volume growth in the March quarter in Indonesia, although Macquarie points out this is attributable to cycling undemanding comparables and there was no boost to sales from the April election. The company has guided to around 5% earnings margin in Indonesia, similar to 2018.

Indonesia may be expected to improve volume growth but this is through the benefit of price reinvestment and Goldman Sachs suspects double-digit growth rates will be unlikely until FY20. That said, the rate of growth is still expected to be higher than the company's core markets in Australasia, as it is a developing market with an average population that is significantly younger.

Growth targets in other regions are expected to be achieved in line with the value proposition but the stock remains at the relatively expensive end of the broker's coverage in relation to global bottlers. A value-accretive acquisition could make a difference, particularly with products that aid in the longer-term development of the company's "Beverages for Life" strategy.

This strategy includes the change of product mix away from carbonated soft drinks. Goldman Sachs, not one of the eight monitored daily on the FNArena database, downgrades to Sell, finding it difficult to justify the current valuation. Target is $8.50, calculated to offer a total return of -14.5%.

Credit Suisse recently downgraded to Underperform from Neutral, and Macquarie downgraded to Underperform in May. Macquarie suggests there are a number of headwinds facing the business and returns and operating expenditure in Australian beverages are uncertain. Moreover, more expenditure is likely to be needed to meet growth targets.

Credit Suisse accepts the sales force investment will drive revenue in 2020, and a -3% decline in Australian earnings, partly affected by the investment in the sales force, is already incorporated into estimates. The broker calculates, even assuming the PE is sustainable, on 2021 estimates there is only 3% potential upside to the share price.

FNArena's database shows four Hold ratings and four Sell. The consensus target is $8.36, signalling -18.9% downside to the last share price. Targets range from $7.70 (UBS) to $9.00 (Morgan Stanley). The dividend yield on FY19 and FY20 forecasts is 4.4%.

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

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

Treasure Chest: More Pain For Computershare?

FNArena's Treasure Chest reports on money making ideas from stockbrokers and other experts. Morgan Stanley is convinced that earnings risks are building for Computershare and the de-rating of the stock is not over.

-Mounting risks in FY20 from UK mortgage servicing -UK specialist lenders budgeting for lower origination volumes -Are lower yields priced in?

By Eva Brocklehurst

Is Computershare ((CPU)) vulnerable to further shocks? The stock is down -20% from peak levels and now trades at a discount to the ASX200 for the first time since 2016. Morgan Stanley is convinced earnings risks are building and the de-rating is not over.

After a three-year upgrade cycle, consensus estimates have now begun to fall and Morgan Stanley expects broadly flat earnings in FY20. Risk is skewed to the downside, stemming from interest rate cuts, corporate actions and possible investment in new growth strategies.

Ord Minnett expects guidance in FY19 will be achieved but agrees the main issue is FY20 and beyond. UBS suggests that while there are near-term headwinds in the UK, there is a stronger story for the company in the US and, in the company's favour, Credit Suisse notes the balance sheet is strong and some capital can be deployed to accelerate growth.

At its investor briefing in May management acknowledged risks in FY20, and possibly beyond, from UK mortgage servicing yet expects more cost savings will help grow the issuer services business.

However, the futures market is pricing in rate cuts and US banks have already begun lowering rates paid for term deposits. Morgan Stanley estimates every -50 basis points cut to the Fed Funds rate drives -5% downgrades to the company's earnings per share. There are also structural risks from US shareholder attrition, escheatment (transfer to the state) of abandoned property and faster payments.

The company is targeting an unpaid principal balance (value of loans under service) in US mortgage servicing of US$150bn with an emphasis on capital-light growth. As of April 30, this was US$101.7bn. Computershare has scale and is seeking growth in adjacent markets, including US registered agents and corporate services. Ord Minnett considers this a good long-term option, albeit unlikely to affect earnings in the near term.

Yet global registry revenue margins are also under pressure and Morgan Stanley notes the company has lost clients to Broadridge, Wells Fargo, Link Administration ((LNK)) and Equiniti.

UK Implications

To offset the earnings hole that will become an increasing drag on trading multiples as investors look at FY21, Morgan Stanley assesses the company needs to lift origination volumes by 2-5 times current levels within 1-3 years.

Having recently met with UK specialist lenders the broker asserts this will not happen. Brexit is constraining the supply of capital and many lenders are budgeting for lower origination volumes. Private equity is reluctant to supply further capital to the sector until Brexit is resolved.

This is not to say that the market is not healthy, as the lenders have observed that demand for mortgages is fine. That said, tax-deductible buy-to-let mortgage interest will be phased out by 2020 and potentially limit demand. All up, the broker envisages a disconnect between trading multiples and fundamental concerns, maintaining an Underweight rating for Computershare.

Management has also noted it is seeking additional cost offsets in mortgage servicing and there are stranded costs left over for another year totalling US$35m, after the merging of the UK Asset Resolution business encountered delays. Weaker property volumes have also resulted in soft organic growth.

Macquarie suspects the market was too optimistic about the organic growth profile of UK mortgage servicing. In May, the broker raised its rating to Neutral from Underperform, following the response in the share price to the company's investor briefing and as overly-optimistic consensus expectations were lowered.

Macquarie incorporates broadly stable yields going forward, expecting later on there will be some yield benefits as around $3bn of hedged balances roll off and are redeployed at higher rates. Yet Morgan Stanley disputes that lower yields are now priced in and the recent downgrade was oversold. The broker believes the FY20 outlook commentary will be the driver of the stock at the results on August 14.

FNArena's database shows seven Hold ratings and one Sell (Morgan Stanley). The consensus target is $16.97, signalling 1.1% upside to the last share price. Targets range from $13.50 (Morgan Stanley) to $18.10 (Credit Suisse, Deutsche Bank).

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

Treasure Chest: Can Alumina Maintain Dividends?

FNArena's Treasure Chest reports on money making ideas from stockbrokers and other experts. Brokers are mindful of the sustainability of Alumina Ltd's returns as global supply moves towards surplus. In contrast, Morgan Stanley is confident yields can be maintained.

-Expansion plans are accretive to valuation and should have limited impact on yield -Uncertainty over the re-start of Alunorte has reduced visibility for 2020 -Is Alumina Ltd more structurally aligned with the industrials ex-banks?

By Eva Brocklehurst

The growth potential for Alumina Ltd ((AWC)) is strong in the medium term and high alumina prices have led to an elevated dividend yield in recent times. Yet can this yield be sustained into the future?

Several aspects of the stock suggest a clear structure and sustainable yield to Morgan Stanley, while other brokers are not so confident. Morgan Stanley assesses Alumina Ltd provides around 25% upside potential and this, coupled with a 7% yield, is significantly higher than mining peers and the industrials ex-banks.

Macquarie, downgrading the stock to Underperform from Neutral, now envisages downside risk to consensus earnings and dividend expectations. The broker reduces its alumina price forecasts - to US$300/t for the long-term and US$340/t for the June quarter - albeit concedes the dividend yield should provide some downside protection.

However, Morgan Stanley asserts expansion plans are accretive to valuation and this should have a limited impact on yield. Furthermore, the broker's forecast also incorporate below-consensus 2020 and 2021 alumina price forecasts at US$335/t and US$340/t, respectively.

These are both above spot prices of US$321/t, signalling upside risk, and the broker believes this is sustainable, driven by a low reinvestment rate. Using bear-case commodity prices, Morgan Stanley calculates, the lowest that the yield can fall is to 5.6% in 2022, still above mining peers. Morgan Stanley has reinstated coverage with an Overweight rating.

Alunorte

UBS envisages potential upside risk to both the alumina price and the company's share price should the re-start of Brazil's Alunorte refinery, the largest outside China, be delayed. A re-start, and additional supply from the rest of the world, is expected to offset reduced Chinese supply of alumina.

Alumina Ltd (which owns 40% of the AWAC JV) maintains a view that the small alumina deficit experienced in 2018 will move into balance in 2019. UBS recalls this balanced market view conflicts with that of Alcoa, the other 60% of AWAC, which is anticipating there will be a surplus of 200,000t-1mt in 2019. UBS expects a market surplus of 800,000t in 2019, rising to 1.9mt in 2021.

At 2020 alumina price forecasts of US$380/t, Citi calculates Alumina Ltd trades on a dividend yield of 11%. Alunorte's uncertain move to full production has reduced visibility on 2020 alumina prices and the broker suspects the pace of China's refinery re-starts will be key.

Citi has reduced its alumina price forecasts by -6% for 2019, to US$366/t, and upgraded 2020 by 2% recently. Yet the stock has risen 12% since early May and now trades in line with the broker's target. Hence, the rating was downgraded to Neutral in June.

More An Industrial?

AWAC operates refineries with very long lives. Morgan Stanley believes this makes the stock structurally closer to industrials but with reinvestment rates that are -50% lower than those of its mining peers. This feature is under appreciated by the market, and gives the impression the yield is more volatile than what the broker's analysis implies.

AWAC maintains a cash position and the company's gearing is negligible. This also lowers the yield risk through the commodity cycle. The production expansions that were recently flagged are positive, while closure costs can be managed.

Morgan Stanley finds that, even in a most aggressive scenario where there is a 10% simultaneous expansion at both Wagerup and Pinjarra, yield could be maintained at 5.4% through the investment phase.

Morgan Stanley also stress-tested the yield for closure costs related to the Portland smelter and Point Comfort refinery and finds the impact is also of the limited nature as well as being short term.

FNArena's database shows two Buy ratings, three Hold and one Sell. The consensus target is $2.55, signalling 9.4% upside to the last share price.

This Too Shall Pass

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

-This Too Shall Pass -The Other Story About Small Caps -Afraid About Growth: Nearmap -Who Invests In Negative Yielding Bonds? -Conviction Calls -Rudi In The Australian -Rudi On Tour -Rudi Talks

This Too Shall Pass

By Rudi Filapek-Vandyck, Editor FNArena

"We expect markets to continue to provide attractive returns for investors but are prepared for an increase in volatility that typically comes with late-cycle investing." [Tracey McNaughton, head of asset allocation, Wilsons Advisory and Stockbroking]

One of the key characteristics of the 2019 bull market rally is not only has the uptrend been exceptionally strong, with the ASX200 Accumulation index up nearly 20% over six months, the average volatility along the way up has been unusually low at the same time.

To illustrate my point, I have put together the monthly returns for the first half of 2019. And just in case anyone needed to be reminded, I also included the monthly performances from the prior four months in 2018:

It is good to remember ourselves that while the overall trend has changed dramatically for equities worldwide, the Big Question Mark that caused the trend to reverse towards the end of 2018 is still intact: is the US economy, and by extension the rest of the world, decelerating towards an economic recession or not?

Before you answer that question, do note I am not going to attempt to answer it myself. Nobody knows the answer. My guess, no matter how well-researched, is as much worth as yours.What we do know is that central bankers are now united in their attempt to prevent worst case scenarios, and governments might join in next with infrastructure spending and more alternative forms of support.

Last year, financial markets sniffed out the rising risk and found central bankers and governments asleep at the wheel. Hence the relentless down-trend. Then came the Fed's public acknowledgement -we received your message- and other central bankers in China, Australia and elsewhere joined in.

Hence the swift trend reversal and relentless, low volatile up-trend over the past six months.

It's easy to now get carried away and put all our trust in the world's leaders and monetary authorities, but the Big Question Mark hasn't been answered yet, and outside of lower bond yields and central banks cutting cash rates, nothing else has changed much. We still need to see concrete evidence of economies stabilising, then trending back upwards.

This might take a while. There is no guarantee financial markets will remain confident and patient. In the meantime, experts, strategists, traders and authorities will be trying to figure out what follows next. The safest bet at this point in time, I believe, is that continuously rising indices on low volatility is not going to last. This too shall pass. Share market weakness on the first two trading sessions this week in Australia might well be the harbinger of what is yet to come.

Morgan Stanley has just declared it is moving to Underweight global equities. Many an institutional wealth manager has been increasing the level of cash in the portfolio recently. Equally noteworthy: many remain positive on Australian equities on a relative basis; meaning they might go Neutral or Underweight equities in Asia or in the US, but are likely to make no changes to their Australian allocation, unless they were Underweighted in the first place.

For investors, it is equally important to understand the positive view on Australia is mostly a relative call, and it happens against a background of equally challenging domestic economic dynamics. As once again became apparent when National Australia Bank released its monthly business survey on Tuesday morning.

This survey is widely seen as the best insight into how businesses are performing in Australia; inside the Reserve Bank building at Martin Place, Sydney as well as among economists and journalists across the country.

"Overall, the survey results for June continue to suggest that the business sector has lost significant momentum over the past year or so. Business confidence largely unwound the bounce in May and while business conditions rose in the month, they remain below average. The recent run of results also suggest that the economy is unlikely to record a significant pickup in growth in Q2. Further, forward orders also remain below average (and are negative), suggesting a near-term turn around in business activity is unlikely."

Thus reads the opening paragraph of the day's press release, in which NAB Group Chief Economist Alan Oster seems to be making the extra effort to emphasise this latest survey suggests investors should not be hoping for significant improvement in the near term (his specific words are "in the next few months").

While the NAB survey explains why investors continue to avoid large swathes of the Australian share market, not confident there won't be a profit warning or disappointing outlook statement forthcoming, or that the worst has now been seen in case that profit warning has already been issued, ultimately the direction of global equities will be determined by corporate earnings, economic data and stimulus actions in China and the USA.

With the Q2 corporate earnings season about to commence in the US, investors will be super-keen to find out what the latest trends and insights are from the bottom up. In Australia, there are still four weeks left before corporate earnings updates will be unleashed on a daily basis.

One mega-trend that needs to be watched closely, and which is unlikely to be impacted significantly by whatever comes out of these corporate profits releases, is what happens on bond markets. Ever lower bond yields -meaning: bonds are rising in price- have had a significant impact on equities, and not only on stocks such as Goodman Group, Transurban and Charter Hall, but equally for Altium, Xero, Carsales and, in fact, equity markets in general.

Bond traders are just as gung-ho as their peers on equity trading desks to price in changes in rate cut projections, and the US market might have been pricing in too much too soon. Any changes over there are poised to impact on equities. As I said earlier, plenty of reasons to get prepared for a less straightforward outlook for equities.

Make sure you also read "The Global Fiscal Panic" published on the FNArena website on Tuesday morning:

https://www.fnarena.com/index.php/2019/07/09/the-global-fiscal-panic/

See also: Crucial Question: Is It 1995 or 2007?

https://www.fnarena.com/index.php/2019/06/27/crucial-question-is-it-1995-or-2007/

Who Invests In Negative Yielding Bonds?

It's a crazy world we are living in with trillions of investment funds parked in negatively yielding government bonds, and with no sign on the horizon this situation is about to change anytime soon.

Negative yields on bonds means investors are paying money for the privilege of owning a loan to the provider (not from, but to). In practical terms, this means investors are given a guarantee they will end up losing money; and still they buy more bonds.

So who exactly is buying these bonds?

When I wrote "Change. Investing in a Low Growth World" I dedicated a few pages to what surely must be a mind-boggling question for most mere mortals among investors: who lends out money knowing it will guaranteed result in a negative return?

GaveKal's Charles Gave recently returned from Europe with another fine example of modern day craziness, which partially answers that question. I thought I'd share it with you:

"When meeting some clients a few weeks ago in Amsterdam, I made my usual remark about the stupidity of running negative interest rates. In response my host told me a sobering story. He manages a pension fund and had recently started to build large cash positions. One day he was called by a pension regulator at the central bank and reminded of a rule that says funds should not hold too much cash because it’s risky; they should instead buy more long-dated bonds. His retort was that most eurozone long bonds had negative yields and so he was sure to lose money. “It doesn’t matter,” came the regulator’s reply: “A rule is a rule, and you must apply it.”"

Rudi In The Australian

My recent story on Australian gold producers got picked up by The Australian newspaper to lead the Wealth section on July 2nd.

Unfortunately, the times when I was able to include a direct link to my story are well and truly past - News Ltd likes to keep its content behind a stringent pay wall.

For those who missed the story, there is always the opportunity to still read the story via the FNArena website:

https://www.fnarena.com/index.php/2019/06/28/which-gold-stocks/

Rudi Talks

Audio interview on Wednesday about how much central bankers are invested in today's financial markets, and how far exactly is this going to take them:

https://www.youtube.com/watch?v=wFktIuKZji4

Rudi On Tour In 2019

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

(This story was written on Monday and Tuesday 8th & 9th July 2019. It was published on the day in the form of an email to paying subscribers, and again on Thursday as a story on the website. Part two follows on Friday).

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

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

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Rudi's View: Afterpay Touch, Nearmap, And a2 Milk

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

-This Too Shall Pass -The Other Story About Small Caps -Afraid About Growth: Nearmap -Who Invests In Negative Yielding Bonds? -Conviction Calls -Rudi In The Australian -Rudi On Tour -Rudi Talks

The Other Story About Small Caps

By Rudi Filapek-Vandyck, Editor FNArena

This truly deserves a dedicated story, based upon more detailed in-depth research, but for now I have to restrict myself to merely pointing out one of my pet observations from the past 17 years: small cap investments can generate large, above average returns, but on average, small caps do not outperform in Australia, despite the fact this is convincingly the case in overseas markets like the USA.

On my non-researched hunches, factors in play locally are smaller average company size (what is mid-cap in Australia is merely small cap in the USA), more mining companies and explorers, different dynamics as Australia is a much smaller economy, and, equally important, a much smaller share market with limited liquidity, in particular during times of economic stress. I have a suspicion the big overweight in local indices towards large banks and resources also plays a role.

Whatever the case, investors shouldn't automatically assume there are no outsized gains to be achieved from large cap names in Australia, with the smaller end of the share market the automatic magnet for investors looking for large upside on offer. The statistics, however, tell a different story.

Below is a recent chart I picked up from Colonial First State. I'd wager the big gap in performance between the Top100 in Australia and the tiddly piddly small cap stocks grouped together in the Small Ordinaries has as much to do with CSL, Brambles, REA Group, the banks, iron ore and Telstra as it has to do with the unusually strong performance for Goodman Group and Transurban and the likes, plus the fact that the investment sweet spot in Australia is situated in between positions 51 and 100 of the ASX200.

For those not familiar with the composition and rankings of the ASX200, the aforementioned sweet spot includes names such as Xero, Fisher & Paykel Healthcare, Magellan Financial, WiseTech Global, ResMed, Afterpay Touch, IDP Education, and many other fast growing upcomers. These have been the little engine that could for the Australian share market for a long time now.

In the USA, each of these names would be part of the small caps index. In Australia, all are part of the ASX100, which is outside the typical hunting ground for small cap funds managers.

The second chart, from Ord Minnett, provides more detail into how small caps in Australia performed throughout fiscal 2019.

Afraid About Growth: Nearmap

Australian investors are not used to dealing with structural growth companies. Hence why the likes of CSL and REA Group do not feature prominently in most investment portfolios (while they most definitely should).

To make matters worse, the general idea that buying cheap looking stocks -otherwise referred to as "value investing"- is the only viable methodology for long term investors, instills the fear of God into many an investor when confronted with rapidly growing success stories including a2 Milk, Pro Medicus, and Afterpay Touch.

Assisted by hopelessly misguided narratives such as "stocks cannot continue to trade above a Price Earnings Ratio (PE) of 15x", the usual response is to criticise from the sidelines and await for the share price to tumble. I have had quite the exchanges via Twitter over the years past!

And, of course, while it is correct to point out the disasters that awaited shareholders in, say, BWX and Speedcast International, it is equally correct to point out that large gains have been made by staying on the shareholders register of the stocks I mentioned earlier, plus many more!

It goes without saying, ever since my own research into All-Weather Performers and in particular since the publication of my book "Change. Investing in a Low Growth World" (2015), I have been genuinely surprised by how deeply engrained the belief about buying cheap looking stocks is as the only sensible investment strategy, despite the accumulating evidence that most cheaply priced stocks are not participating in the bull market for very good reasons.

Yes, I know, the generalisation is over the top as some cheap looking stocks successfully turn around and become highly profitable investments for multiple years after. But here's a personal observation I believe can withstand the test of closer scrutiny: I am convinced more money gets lost every year in the Australian share market through investors trying to pick bottoms, turnarounds and cheap looking stocks in general, than on the other side of the ledger where growth stories occasionally experience a hiccup.

The decade-long outperformance of Growth over Value (in the US. In Australia the story is only six-seven years old) is not pure coincidence, and neither do I believe it is simply cyclical as some experts have been arguing. I believe it is as much the result of a thoroughly changing world as is president Trump inside the White House.

And, yes, I agree it is most likely that Growth stocks will ultimately end up being priced too expensively, potentially into stratospheric valuations, but good luck with trying to time that story. Meanwhile, many among today's laggards will simply remain that, laggards. They'll never catch up, and if occasionally they do, it is highly unlikely to last.

Which takes me to a recent conversation I had after my presentation to members and guests of the Australian Investors Association (AIA) in Adelaide. As has become pretty standard, my presentations contain lots of charts and statements like you just have been reading in prior paragraphs.

With part of the crowd gathering around me, firing away questions about how much growth can this or that company possibly still have up its sleeve and why another company cannot get its share price moving away from the bottom, one statement was thrown at me about Nearmap ((NEA)) by someone who said he had a long career inside the industry.

Here is where things get genuinely interesting. Why do you think the share price is in a bubble, I responded, other than that the share price has doubled this year, which is no evidence at all, believe it or not?

The answer came swiftly: the company is trying to replicate its success in the USA, but over there it has to deal with much larger and better equipped competitors. It's only a matter of time before investors in Australia come to realise this!

My response: the fault in your thinking is that Nearmap needs to take the whole of the American market. It doesn't. Do you know what A2 Milk's market share in China is? It's less than 3%. Have you looked at what achieving 3% in China has done to the A2 Milk share price?

Currently analysts are excited about A2 Milk's growth prospects in North America. A recent report by UBS projected A2 Milk's US market share to grow to 2% in the years to come. That's even less than the 3% in China. Watch what happens if Nearmap successfully builds out a network of loyal customers in America. You won't recognise the share price, irrespective of the gains already booked this year.

And this, as they say, is the crux of investing in small cap growth stories. They start from nothing, so everything looks promising and exciting in the early stages, but success does not come only by wrapping up the whole wide world and growing into the next Facebook or Alphabet or Amazon. Accountancy software provider Xero will never be the sole standard for its industry in every single country. It cannot even achieve that status here in Australia. The same principle applies to Altium, and to Nanosonics, and to Appen, and to WiseTech Global, and a number of others.

The Australian share market has become the home ground for some extremely exciting growth stories, with lots of potential left for the next decade, but the main danger is many an investor will not benefit because he/she is afraid of PEs above 15x, the absence of a high yield, or this idea that Australian companies simply can never achieve success for long when venturing overseas.

The latter might be true upon reflection about how Foster's had to withdraw from China, how QBE Insurance lost billions overseas, while nobody has forgotten about National Australia Bank, or Telstra, or Wesfarmers.

The other side of this story is that high quality, well managed companies starting life in Australia have been extremely successful overseas for many decades. From News Corp, to Computershare, to Westfield, ResMed, Cochlear, and the two resources giants, BHP Group and Rio Tinto.

Carried by the increasing digitisation of the global economy, local growth stories such as Nanosonics, Appen and WiseTech Global are ready to potentially add the next chapter. And yes, Nearmap is part of the burgeoning new generation of Australian businesses as well.

Is ultimate success guaranteed? Of course not! But neither is failure. And that is the long and the short of this story.

Earlier in the year I launched the CSL Challenge (click here) -most likely the most successful growth story in the Australian share market of our generation. Apart from finally pulling investors on board of this tremendous success story, I remain of the view that observing, studying and learning from CSL will prove an invaluable asset for most investors.

If anything, it'll help understand what makes an exceptional company, with the ability to apply such insights when selecting emerging growth stories, plus it also cures the fear of owning shares trading on a PE higher than 15x. Honestly, I cannot even remember the last time CSL traded on a PE of 15X or lower.

As anyone can see from the historic price chart for the CSL share price, that hasn't stopped this large cap champion from pampering loyal shareholders with plenty of above average returns over a very long horizon. It is never too late to join the CSL Challenge, or to start researching local growth stories.

It is my intention to update the various lists that make up the All-Weather Performers section on the website, as well as write up the next update for the CSL Challenge. Thus far this year time has run ahead of my intentions, and with the August reporting season looming, as well as the annual conference of the Australian Investors Association, both updates are most likely to occur in September.

The next update will see Nearmap included in the selection of Emerging New Business Models. The stock has recently been added to the All-Weather Model Portfolio.

To read up on and join the CSL Challenge:

https://www.fnarena.com/index.php/2019/01/14/rudis-view-join-the-csl-challenge/

Conviction Calls

Ord Minnett has removed Afterpay Touch ((APT)) from its Best Stock Ideas. The reason? An increase in competitive threat now that Visa has announced its intention to also move into the buy-now, pay-later arena. The analysts note Afterpay Touch had become a Conviction Buy in January 2018 and generated a return of no less than 217% over the period.

Ord Minnett's list of conviction calls consists of four sub categories. Below are the remaining names for each of the four sub-divisions:

Core Blue Chip: -ANZ Bank ((ANZ)) -APA Group ((APA)) -CSL ((CSL)) -GPT Group ((GPT)) -Oil Search ((OSH)) -Rio Tinto ((RIO)) -Sonic Healthcare ((SHL))

Value/Income -AusNet ((AST)) -Charter Hall Long WALE REIT ((CLW)) -Event Hospitality and Entertainment ((EVT)) -National Australia Bank ((NAB)) -Perpetual ((PPT))

Growth -Ansell ((ANN)) -Aristocrat Leisure ((ALL)) -Boral ((BLD)) -Charter Hall ((CHC)) -QBE Insurance ((QBE)) -ResMed ((RMD)) -WorleyParsons ((WOR))

Small Caps -Alliance Aviation Services ((AQZ)) -Austal ((ASB)) -Clover ((CLV)) -Hub24 ((HUB)) -Integral Diagnostics ((IDX)) -Pacific Current Group ((PAC)) -Service Stream ((SSM)) -Viva Energy REIT ((VVR))

**** Also, the Equity Strategy Portfolio at Macquarie has traded in Treasury Wine Estates ((TWE)) for A2 Milk ((A2M)) while also preferring defensive exposures that are not so much reliant upon bond yields continuing to move lower.

Macquarie thinks typical bond proxies have done more than their dough in recent months and likely to underperform from here onwards.

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Portfolio managers at Baillieu have been making a number of adjustments post mid-year re-assessments. This has led to buying more shares in Milton Corp ((MLT)) and selling out of Monadelphous ((MND)) and Vocus Group ((VOC)), while reducing exposure to Macquarie Group ((MQG)).

Their peers at stockbroker Morgans have been topping up on Oil Search ((OSH)) and on Telstra ((TLS)), while reducing exposure to Aristocrat Leisure ((ALL)) and People Infrastructure ((PPE)).

Rudi In The Australian

My recent story on Australian gold producers got picked up by The Australian newspaper to lead the Wealth section on July 2nd.

Unfortunately, the times when I was able to include a direct link to my story are well and truly past - News Ltd likes to keep its content behind a stringent pay wall.

For those who missed the story, there is always the opportunity to still read the story via the FNArena website:

https://www.fnarena.com/index.php/2019/06/28/which-gold-stocks/

Rudi Talks

Audio interview on Wednesday about how much central bankers are invested in today's financial markets, and how far exactly is this going to take them:

https://www.youtube.com/watch?v=wFktIuKZji4

Rudi On Tour In 2019

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

(This story was written on Monday and Tuesday 8th & 9th July 2019. It was published on the day in the form of an email to paying subscribers, and again on Thursday as a story on the website. Part two follows on Friday).

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

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

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

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