

## NEXT Daily – 13<sup>th</sup> May 2010

### Overseas

The **Dow Jones** rose 148 pts or 1.38% to 10,896.91 (YTD 4.50%), **S&P 500** rose 15 pts or 1.37% to 1,171.67 (YTD 5.07%) and the **NASDAQ** rose 49 pts or 2.09% to 2,425.02 (YTD 6.87%)

The **FTSE** rose 49 pts or 0.92% to 5,383.45 (YTD -0.54%), **Nikkei** fell 17 pts or 0.16% to 10,394.03 (YTD -1.45%) and the **Hang Seng** rose 65 pts or 0.33% to 20,212.49 (YTD -7.59%)

Oil fell \$0.79 to \$75.58 a barrel.

Gold rose \$5.53 to \$1,238.40 an ounce.

Base metals were mixed with Copper down 0.35% to \$317.03, Zinc rose 1.51% to \$93.84 whilst Aluminium was up 0.84% to \$94.82 and Nickel fell 0.18% to \$1,019.63.

BHP ADR's trading at \$38.40 vs the Aussie close of \$38.15.

SPI 200 Futures closed up 63 pts at 4,646.

### Ideas

**Markets rallied overnight with some encouraging news out of Europe overnight, however JP Morgan highlight that their offshore traders noted "Europe appears to be healing, but investors want to see calm markets for a couple weeks before declaring all clear."** Euro area GDP rose modestly in Q1 in all countries except Greece which recorded a negative rate of growth. Portugal had a successful bond sale; Spain unveiled further austerity measures. Also Greece received the first EU5.5B of the EU/IMF bailout according to Reuters and the country is increasingly expected to meet next week's bond payment. The US was lifted by the positive news out of Europe and a profit upgrade from IBM which was up 4.6% and added 44pts to the Dow. The major banks underperformed the broader financial segment as the Senate debated regulatory-overhaul legislation, adopting new mortgage-underwriting rules and an amendment to retain the Federal Reserve's oversight of community banks. The big end of town was also unsettled by reports that federal investigators are probing whether Morgan Stanley misled investors about mortgage derivative products it helped create and sometimes bet against.

**Tuesday saw a raft of data released from China. Royal Bank of Scotland (RBS) summarised the data, stating that reported inflation measures are slightly worse than expected and growth measures are mixed. This data suggests incremental easing in the growth outlook, but won't completely offset rate hikes fears.** RBS think the market will stay concerned about rate hikes after the data release, but the real issue is growth, particularly as easy comparisons fade in 2Q10. RBS said based on their checks and given the credit events in Europe and what it means for the €/US\$, US exports and job creation, we think growth will be more of a concern for China in 2H10 than it was a month ago. As such, both interest rate hikes and Rmb appreciation are less likely than a month ago. Further to this RBS said before they get too excited, we may see consensus trimming the 2Q10 GDP outlook while inflationary measures inch higher in the coming months. RBS continue to recommend a defensive portfolio bias with a preference for cash, telecoms, expressways and agriculture.

**In an extraordinary turnaround after spending 2008 trying to sell assets as it strained to cut ballooning debt, RIO Tinto's Chief Executive Officer Tom Albanese now has the opposite challenge -- to decide how to spend his swelling pile of cash.** According to Bloomberg Rio will have \$24.5 billion in cash next year, according to the median of nine analyst estimates compiled by Bloomberg News. That compares with \$42 billion of debt the

company had after the 2007 takeover of Alcan. Bloomberg said the shift in fortunes, driven by asset sales and surging commodity prices, may spur Albanese, 52, to make a major acquisition for the first time since Alcan almost three years ago. Rio has “firmly re-instated” takeovers as a growth option and won’t be discouraged by Australia’s planned tax on mining company profits, according to JPMorgan.

**Following the wrap up of the bank reporting season yesterday, Credit Suisse (CS) has produced a comprehensive review of the bank sector.** In summary CS continue to be market weight the banks sector, albeit with a modestly negative bias to this given that fundamentals appear to be much more negatively than positively biased. Cs made the following points in terms of valuations, industry fundamentals and earnings momentum:

- Bank sector valuations do not appear to us to be demanding, yet not compellingly inexpensive either: Major bank stocks are currently trading on 12-month prospective PEs of 10.9x-12.3x (towards the lower end of a traditional 11x-14x PE range), with corresponding net dividend yields of 5.8-6.4%, and book multiples of 1.6x-2.4x. However, towards the end of CY2010 we might see multiple expansion as a consensus emerges that the cash rate tightening cycle has peaked (bonds usually rally from this point, prima facie benefiting bank stock multiples). We are now also virtually through the seasonal bank dividend harvesting season (twice a year in the lead-up to interim bank reporting season, bank stocks have in >60% of episodes since 1998 outperformed the ASX 200 index from operating period end to the eve of trading ex-dividend).
- Bank sector fundamentals appear even more challenging than before reporting season: Revenue growth is under pressure from: a) Subdued lending growth (MoM business credit growth has merely stabilised, so we see it as premature to call a recovery here), b) The re-emergence of margin compression (including the stirring of competition both from within the major bank oligopoly and from without); c) Full-period impacts from exception fee cuts; and d) Normalisation of financial markets and treasury income (albeit this might remain at elevated levels for some time). Cost growth, while not undisciplined, is nevertheless characterised by simultaneous franchise investment initiatives, rather than austerity measures. Bad debt charges are normalising more quickly than expected, bringing into sharp relief the weakness in underlying profits. ROE expansion will increasingly be curbed by high and increasing Tier 1 ratios.
- Bank earnings momentum appears to have stalled for the immediate term: We see scope for positive bank earnings momentum as: a) System credit growth improves (modestly already reflected in our estimates); and b) Clarity emerges regarding regulatory reforms to permit banks to monetise the value of their considerable collective provision coverage and high Tier 1 ratios into lower bad debt charges and capital management respectively (both already modestly reflected in our estimates).
- Regulatory and political risk are unpredictable themes in an election year, but best to be cautious of: The ACCC.s decision in relation to the NAB/AXA proposal is a regulatory development that has arguably reduced the acquisition risk of the major banks domestically (a positive for bank stock multiples). Clarity in relation to the impact of regulatory reform could take some time to emerge, with the Basel Committee draft capital standards not due until end CY2010 and APRA draft liquidity standards not due until mid CY2011 (albeit grandfathering/transitional period arrangements can moderate the financial shock). Our base case expectation is that regulatory risk impact will be manageable. However, a wide range of potential outcomes is feasible, given the politically charged nature of bank regulatory reforms (especially in the Northern Hemisphere), and the uncertain extent to which an attempt to globally standardise bank regulations can be balanced out with appropriate considerations of the Australian financial system (eg. the proportionate

size of the pension industry in Australia). We see potential political interference in the banking industry domestically as relevant in an election year in Australia, especially given ongoing public statements from the Federal government regarding major bank mortgage pricing, and its apparent commitment to the G20 reform agenda, which we believe is at risk of being more likely tailored to US and European (rather than Australian) banking conditions. Finally, any concessions that the sector might be granted (eg. the deposit growth benefit that would be expected to flow from the tax concessions on bank deposits) arguably will not be granted to the industry without a corresponding cost elsewhere.

## Research

CSR Limited (\$1.70) – Following the announcement of CSR's FY10 results ahead of market expectations, Deutsche, Macquarie, Credit Suisse and UBS have retained a BUY whilst GSJB Were and JP Morgan maintained a HOLD and Citigroup has **upgraded** to a HOLD. Deutsche has a price target of \$2.48.

Nufarm Limited (\$6.50) – With the completion of the institutional side of NUF's recent capital raising, UBS has **downgraded** to a HOLD with a price target of \$7.00.

SP AusNet (\$0.90) – With SPN delivering a solid FY10 result, Deutsche and Macquarie have maintained a BUY, Credit Suisse, UBS, JP Morgan, RBS and Citigroup have retained a HOLD whilst GSJB Were has reiterated their SELL. Macquarie has a price target of \$1.10.

Commonwealth Bank of Australia (\$54.30) – Following their 3Q10 trading update, Credit Suisse, Macquarie and UBS have maintained a BUY whilst Citigroup, Deutsche, GSJB Were and JP Morgan have retained a HOLD. Macquarie has a price target of \$66.50.

Programmed Maintenance Services Limited (\$2.94) – With PRG to refocus its attention on domestic operations, Citigroup, Deutsche, UBS, GSJB Were, Macquarie and RBS have retained a BUY whilst JP Morgan has maintained a HOLD. GSJB Were has a price target of \$4.23.

The Mac Services Group Limited (\$2.41) – Following recent share price performance, Credit Suisse has **upgraded** to a BUY with a price target of \$3.05.

CSG Limited (\$2.01) – Following the completion of a printer acquisition of a Canon MFD dealership, RBS has **upgraded** to a BUY with a price target of \$2.44.