

NEXT Daily – 2nd June 2010

Overseas

The **Dow Jones** fell 112 pts or 1.11% to 10,024.02 (YTD -3.87%), **S&P 500** fell 18 pts or 1.72% to 1,070.71 (YTD -3.98%) and the **NASDAQ** fell 34 pts or 1.54% to 2,222.33 (YTD -2.06%).

The **FTSE** fell 25 pts or 0.48% to 5,163.30 (YTD -4.61%), **Nikkei** fell 56 pts or 0.58% to 9,711.83 (YTD -7.91%) and the **Hang Seng** fell 268 pts or 1.36% to 19,496.95 (YTD -10.86%)

Oil fell \$1.33 to \$72.64 a barrel.

Gold rose \$9.70 to \$1,225.90 an ounce.

Base metals were weaker with Copper down 2.78% to \$304.77, Zinc fell 4.45% to \$82.54 whilst Aluminium was down 2.68% to \$88.85 and Nickel fell 4.01% to \$926.42.

BHP ADR's trading at \$37.62 vs the Aussie close of \$38.19.

SPI 200 Futures closed down 51 pts at 4,359.

Ideas

Listless trade gave way to a broad-based selling last night in the US after market participants returned from the extended holiday weekend with several of the same problematic themes of recent weeks still at the fore. Worries about the state of finances in Europe continue to linger, but news that the European Central Bank (ECB) said that eurozone banks face further writedowns over the next 18 months added to concern. Europe's major bourses buckled and the euro fell to a new four-year low of \$1.211 in response. Meanwhile, concerns about global growth came back into play in the wake of weaker-than-expected monthly manufacturing data from China. In the face of the market's growth concerns, the Bank of Canada announced that it added 25 basis points to its benchmark interest rate, which now stands at 0.50%. The hike makes Canada the first G-7 country to raise rates. U.S. data showed that the ISM Manufacturing Index for May hit 59.7, which is a bit better than the 59.4 that had been widely expected. Moreover, construction spending for April surged 2.7%, which easily surpassed the 0.1% monthly increase had been widely anticipated, to make for the best monthly increase since 1998. Those announcements helped stocks swing from an early loss of more than 1% to a solid gain. A pullback by the greenback also helped stocks, but the dollar was later able to stage a modest rebound so that it finished with a 0.3% gain against a basket of competing currencies. Though stocks looked like they were on course for an impressive turnaround, trade quickly turned muddled. The lack of positive leadership left stocks susceptible to a late selloff, which focused on cyclical plays like materials stocks and energy stocks.

In Australia the RBA left the cash rate unchanged, as widely expected, its first monthly pause in 4 months. UBS said that not surprisingly, the RBA has retained its optimistic outlook, though arguably, it appears a little less punchy in its press release this month. UBS commenting on the RBA statement said:

The RBA spent quite a bit of time discussing the shift in developments since May (when it hiked), noting investor caution, falling equity prices and bond yields, as well as commodity prices (though it noted those most relevant to Australia remained at very high levels). As such, the outlook for the 'world economy will need to remain under review', and the RBA slightly downgraded its view from 'trend pace or a little above' to just 'about trend' for 2010. The RBA noted (like last month) 'more established' growth in the US and 'strong' growth in Asia, although on the latter, it added (strangely) that growth 'may need to moderate in the year ahead. On the

domestic economy - well it looks like someone hit 'delete!' No discussion of housing, credit growth, retail, employment...or Q1 GDP? Is it too soft to mention? Instead, it repeated its (very top down) view that Australia's rising terms of trade/commodity prices, and the impact this is likely to have on the incomes and output growth were still seen to be a more dominant driver of growth than fading 'earlier expansionary policy measures'. Inflation, again, was seen in the upper half of the target zone. On balance, with borrowing rates 'being close to the average experience' over the past decade - and no longer at an emergency setting - the RBA now appears more willing to take some time to assess future prospects for demand and inflation... It is likely that the RBA holds a more optimistic medium term outlook that's not being reflected in recent run of data. But the more optimistic view remains more likely, nonetheless. In our view, if risk of broader contagion in Europe remain contained and as the world recovers moderately (even as there's some sequential slowing in EM & China) it's likely that a sustained relatively high level of commodity prices and associated strong investment outlook - together with a trend lower in the unemployment rate - will need the cash rate somewhat higher, overtime, than its current 4.5%. But with much work already done, we continue to expect the RBA to hike more slowly from here - targeting 1 rate hike per quarter, taking the cash rate to 5.5% by mid 2011.

CSL announced yesterday that it would voluntarily recall any remaining paediatric flu vaccine in Australia. This follows an order from Australian regulators (TGA) to insert a warning on the product label relating to higher risk of convulsions in young children. The Australian Health Department is continuing to investigate the cause of higher than anticipated reactions to flu vaccination among infants and has continued its ban on flu inoculations for young children. UBS says there has been a range of theories, including prior swine flu vaccination were mooted, but tests on the vaccine batches and inspection of CSL manufacturing facilities have proved inconclusive. UBS understands that CSL has 'sold out' its Australian flu vaccine products early in the season this year due to high demand and competitors not supplying the market. UBS says it is not clear whether US FDA will review the Australian decision for the US flu season (US season normally starts Aug/Sep). CSL's equivalent product Afluria is for approved for use in infants aged six months and older by the US FDA. The financial impact of the Australian 'retrieval' is unlikely to be material considering the small outstanding volumes involved said UBS.

Downer (DOW) yesterday announced a significant project write off and earnings downgrade which saw it sold off aggressively yesterday. Credit Suisse (CS) highlighted the main points of the announcement as:

- 1) FY10F guidance downgrade:** FY10F earnings are now subject to significant items (-\$199mn NPAT). This includes \$14mn of customer contract write offs. We believe this represents a normal cost of a contracting business. Excluding this write off, earnings are forecast to fall 2.5% YoY (implies 7% guidance miss);
- 2) Waratah train contract write off:** \$190mn, or four years of rail segment earnings. The contract is now forecast to lose \$40mn EBIT. Importantly, the project is only 30% complete, suggesting ongoing execution risk remains;
- 3) Other asset impairments/write offs:** \$70mn EBIT, including UK Works (despite no apparent change to growth/acquisition strategy), NZ Consulting (\$22mn), and customer contracts; and
- 4) Increased probability of an equity raising:** following the write down and recent FMG contract (\$200mn of capex investment required). We believe significant organic growth is now dependent upon a dilutive equity raising (CS now assumes a \$250mn equity raising in FY11F).

CS believes DOW management has seemingly not learned the lessons from recent history. The new management team has now been at the helm for over two years. This should have

provided ample opportunity to assess the risks (both financial and execution) of the Rail PPP contract. Importantly, the quality of its order book and contract execution has again proven inferior to its peers. CS highlighted that DOW is trading at a 50% discount to the broader sector and that this value gap is unlikely to be realised while the ongoing contractual and financial uncertainty remains.

Research

Metcash Limited (\$3.94) – With MTS reporting results in line with forecasts, GSJB Were, Macquarie and UBS have maintained a HOLD whilst JP Morgan retains a SELL and Credit Suisse is **downgrading** to a SELL. GSJB Were has a price target of \$4.80.

Downer EDI Limited (\$4.58) – Following the announcement that DOW will have write-offs totalling \$199m after tax, Credit Suisse and UBS have retained a BUY whilst GSJB Were, Macquarie and JP Morgan have **downgraded** to a HOLD. JP Morgan has a price target of \$7.33.

CFS Retail Property Trust (\$1.90) – With a tougher and more uncertain sales environment, JP Morgan has **downgraded** to a HOLD with a price target of \$1.97.