

NEXT Daily – 9 June 2010

Overseas

The **Dow Jones** rose 123 pts or 1.26% to 9,939.98 (YTD -4.68%), **S&P 500** rose 11 pts or 1.10% to 1,062.00 (YTD -4.76%) and the **NASDAQ** fell 3 pts or 0.15% to 2,170.57 (YTD -4.34%).

The **FTSE** fell 40 pts or 0.81% to 5,028.15 (YTD -7.11%), **Nikkei** rose 17 pts or 0.18% to 9,537.94 (YTD -9.56%) and the **Hang Seng** rose 109 pts or 0.56% to 19,487.48 (YTD -10.90%)

Oil rose \$0.47 to \$71.91 a barrel.

Gold fell \$2.85 to \$1,237.40 an ounce.

Base metals were stronger with Copper up 1.10% to \$278.24, Zinc rose 6.64% to \$77.22 whilst Aluminium was up 2.90% to \$85.64 and Nickel rose 1.54% to \$835.15.

BHP ADR's trading at \$37.23 vs the Aussie close of \$37.02.

SPI 200 Futures closed up 7 pts at 4,401.

Ideas

The US market spent much of the day again hugging the flat-line but managed a late rally into the close. Bernanke's comments this morning helped sentiment, but he didn't really say anything too incremental. "My best guess is we will have a continued recovery, but it won't feel terrific," Bernanke said. "That's because economic growth won't be robust enough to quickly drive down the unemployment rate, now at 9.7%". Bernanke did say the Fed won't be able to wait until the jobs market is fully healed before it pushed rates up. The European "bailout" was approved last night by the Eurogroup of finance ministers, but this was really just a cosmetic action as parliamentary approvals had occurred weeks prior; meanwhile, investors continue to doubt whether this mechanism will prove successful. Investors continue to have doubts about the ability of certain European countries to get their fiscal houses in order while there is a growing fear that cuts are going to wind up being too steep and will tip the region back into a steep downturn (the fact Germany has got onboard the cutting campaign is spooking people who had hoped it would be an offset to tightening occurring at the peripheral).

With the recent bout of risk aversion driven primarily by increasing concerns around sovereign debt levels, and the potential long term implications this will have on global growth has caused strategists to review what "market" PE will investors be prepared to pay in the coming months. Goldman Sachs JBWere & Macquarie have both written interesting pieces regarding what is the appropriate PE for the market given the current macro environment and volatility.

The PE multiple is generally viewed as a relative valuation metric, reflecting investors views on earnings growth, volatility and strategic risks and also incorporating the outlook for inflation and interest rates. Its key advantage is its simplicity, the ability to compare valuation metrics across industries, and its long history providing a solid benchmark for investors to reference current multiples.

The assumptions that a sustained period of lower earnings growth should result in a lower PE multiple has some basis. However, based on our analysis, the PE reduction should be relatively modest and appears to be largely reflected in current market valuations. The concept that PE multiples should be heading back to levels closer to 10x (or below) on a sustainable basis we find difficult to reconcile – unless inflation expectations were to increase significantly, thereby increasing the risk and volatility of corporate earnings.

Current markets multiples appear to more than reflect the potential for a sustained period of lower growth. This is particularly in light of the low starting base for earnings and the longer term growth potential of the Australian economy given its strong population and corresponding productivity growth.

Macquarie's strategy team highlight the following key points:

We believe that there is a high probability that we are returning to the short and sharp economic cycles seen in the 1970s and 1980s. In this environment, increasing political intervention via regulation and taxation together with sustained strong public spending created high economic volatility. This volatility in turn will likely drive frequent swings in risk appetite and shorten investor's time horizons.

In short, sharp cycles, the price investors are prepared to pay for future earnings growth tends to diminish under uncertainty. And so the market's PER multiple over time tends to compress, driven by macro signals that become the dominant driver of share prices rather than actual profit delivery. That is, the economic cycle is so short that by the time improved company earnings are starting to be delivered, the economy is already showing signs of entering its next downturn. In these conditions, stock investing in the market becomes more like investing purely on anticipation of the cycle - you "buy the rumour" of improving earnings to come and you sell out before these earnings are actually due to be delivered.

Under this lower on average growth scenario, our analysis suggests the Australian market's long term PER would fall by approximately 15.1% over time i.e. the 1-yr fwd PER would fall to 12.3x. It is also notable that the growth cycle on average is lower but also more volatile. This suggests the band around this long-term PER (ie the band both above and below this "average or long term" band that the market PER trades) is also wider.

Research

Brambles Limited (\$6.26) – Following ConAgra's defection to rival iGPS, Macquarie has **downgraded** to a SELL with a price target of \$6.57.