

NEXT Daily – 23 June 2010

Overseas

The **Dow Jones** fell 148 pts or 1.43% to 10,293.52 (YTD -1.29%), **S&P 500** fell 17 pts or 1.61% to 1,095.31 (YTD -1.61%) and the **NASDAQ** fell 27 pts or 1.19% to 2,261.80 (YTD -0.32%).

The **FTSE** fell 52 pts or 0.98% to 5,246.98 (YTD -3.06%), **Nikkei** fell 125 pts or 1.22% to 10,112.89 (YTD -4.11%) and the **Hang Seng** fell 93 pts or 0.45% to 20,819.08 (YTD -4.82%)
Oil fell \$0.62 to \$77.20 a barrel.

Gold rose \$7.05 to \$1,240.75 an ounce.

Base metals were mixed with Copper up 0.10% to \$298.57, Zinc rose 1.08% to \$79.81 whilst Aluminium was down 0.12% to \$87.44 and Nickel fell 1.01% to \$888.04.

BHP ADR's trading at \$39.11 vs the Aussie close of \$39.66.

SPI 200 Futures closed down 48 pts at 4,503.

Ideas

The US market sold off in the afternoon after a directionless morning although there was no obvious reason apart from the housing data that was more or less expected with just the timing surprising. Investors were blaming a number of reasons including a strong 2 year note auction, weak housing numbers and technical reasons ... none of which were very compelling said JP Morgan (JPM). The heaviest hits were taken in energy (-2.7%), utilities (-2.5%), industrials (-2.4%), materials (-2.2%), and discretionary (-2.2%). Transports, viewed as a great barometer for general economic sentiment/strength, were one of the weakest groups (-3.6%). Telecoms (-0.6%), healthcare (-0.9%) and tech (-0.9%) were the best of a bad bunch. The main catalyst was disappointing existing home sales which fell 2.25% to 5.66 million in May from a revised April figure of 5.79 million. JPM said since March, sales had been growing strongly with the home buyer tax credit, growing 7% in March and 8% in April. Although the home buyer tax credit's deadline to sign a contract was April 30, the deadline for completing a home purchase associated with the tax credit is not until June 30. So the decline post the stimulus was expected but it has come earlier than anticipated. The results were mixed regionally, the decline was solely in the Northeast where sales dropped over 18% in May, sales in the South and Midwest held about flat, while sales in the West increased almost 5%.

Macquarie Equities (ME) have increased their overweight positions to both RIO and BHP in their recommended portfolio. ME said the strong US manufacturing recovery remains on track. China has slowed but appears likely that the authorities will soon moderate their restrictive policies (the floating of the Renminbi helps also). Europe is now at least trying to deal with its problems. All of this suggests that the macro environment for commodity prices is once again moving to the positive. **RIO** in particular, but also **BHP**, are both trading near their lowest valuations seen over the past two decades at a time when their earnings growth outlooks remain very strong. ME outlook is as follows:

- The world remains a very mixed picture; however the outlook does appear to be tilting decisively towards the positive over the next year. Most importantly the largest manufacturing recovery seen in the US for over 35 years remains firmly on track. This is in turn delivering very strong US corporate earnings growth (35.2% in CY10 and 17.6% in CY11). We expect US investors to increasingly focus on their own strong domestic outlook and turn their attention away from the problems in Europe. The latter is struggling but will likely slide from the headlines

as the strong monetary stimulus now in place buys the region time to rationalise its unwieldy banking system.

- China is slowing from the extreme growth rates of early this year. However events there are moving quickly. The coastal property markets have already slowed dramatically, especially in transaction volume terms. Recent manufacturing and inflation numbers have also softened. We expect that over the next few months, Chinese authorities will slowly soften their language on property and other economic restrictions imposed earlier this year with a view to ensuring a "soft" landing of about 8% real GDP growth.
- The OECD leading indicator for China has already begun to slow its rate of decline in the last few months... The month-on-month ppt change in the China leading indicator (6 month annualised growth rate) is now just -1.3ppts compared to the peak monthly fall of -3.2ppts early this year (see chart on front page). Another three months and this indicator will likely be moving sideways, that is the currently negative delta is now swinging towards the positive.
- By the December quarter 2010 the northern Pacific region should be firmly back on the economic front foot. Commodity prices have been resilient thus far this year, so any improvement of the economic rate of change should have a meaningfully positive effect.
- There is currently a large divergence in the direction of earnings revisions with Australia. The resources sector has recently seen a strong earnings rebound as the revisions ratio now stands at a buoyant 1.4x. By contrast the Industrials sector has continued to slide towards a revisions ratio of 0.5x under the pressure of higher local interest rates which have slowed the housing, consumer and business investment sectors. This rapid and recent divergence should result in investment flows targeting resources at the expense of industrials over the next few months.
- The valuation of the mining sector remains very low with the Price/Gross Cash Flow multiple for the sector now just below 7x, the lowest since the GFC and more importantly in the bottom quartile of valuations seen over the past thirty years and some 19% below the long-term average.
- **RIO** remains the standout cheap stock in the Australian market as the relative PER valuation stands at a 34% discount to a market PER, which is also undervalued. For only a few months in the depths of the GFC was RIO more heavily discounted, while balance sheet risk is no longer a contributing factor following the equity raising of last year. The relative PER has continued to fall in recent weeks due to earnings upgrades following increases in iron ore forecasts.
- The valuation case for **BHP** is not as strong, nevertheless the relative PER is comfortably below the long term average. Importantly for both stocks the strong earnings upgrade trend is delivering one year forward EPSg forecasts of 52% for BHP and 83% for RIO. Both forecasts are several multiples of the one year forward All Industrials EPSg forecast, which stands at just 15%.

Research

Stockland (\$4.05) – Following the share price strength in recent months, UBS has **downgraded** to a SELL with a price target of \$3.90.

DWS Advanced Business Solutions Limited (\$1.49) – With DWS' solid share price performance, UBS has **downgraded** to a HOLD with a price target of \$1.55.

Elders Limited (\$0.44) – Following expectations of an underlying loss for FY10, GSJB Were, Wilson HTM and Macquarie have retained a HOLD whilst Deutsche has **downgraded** to a HOLD. GSJB Were has a price target of \$0.54.

Pharmaxis Limited (\$3.12) – With PXS' US Phase 3 CF data release, Wilson HTM has retained their BUY whilst Credit Suisse has **downgraded** to a HOLD with a price target of \$3.50.