

NEXT Daily – 28 June 2010

Overseas

The **Dow Jones** fell 8 pts or 0.09% to 10,143.81 (YTD -2.73%), **S&P 500** fell 3 pts or 0.29% to 1,076.76 (YTD -3.44%) and the **NASDAQ** rose 6 pts or 0.27% to 2,223.48 (YTD -2.01%). The **FTSE** fell 53 pts or 1.05% to 5,046.47 (YTD -6.77%), **Nikkei** fell 190 pts or 1.92% to 9,737.48 (YTD -7.67%) and the **Hang Seng** fell 42 pts or 0.21% to 20,690.79 (YTD -5.40%) Oil rose \$2.35 to \$78.86 a barrel.

Gold rose \$12.15 to \$1,255.60 an ounce.

Base metals were mixed with Copper up 1.14% to \$305.85, Zinc fell 0.01% to \$83.53 whilst Aluminium was up 1.77% to \$89.37 and Nickel rose 1.82% to \$892.62.

BHP ADR's trading at \$38.89 vs the Aussie close of \$38.80.

SPI 200 Futures closed down 3 pts at 4,414.

Ideas

US stocks ended mixed on Friday night with the major bourse little changed; banks rallied after Congress finally settled on a financial-reform bill. The legislation, now called the Dodd-Frank bill, now goes to the full House and Senate for a vote and could be signed into law by President Obama by July 4. The bill waters down Dem. Sen. Blanche Lincoln's proposal to make banks spin off their swaps-trading desks after several lawmakers threatened to vote against the legislation on the grounds that such a provision would force trading overseas. Financial Regulation Reform still needs to pass the Senate – this weekend, Republican Senator Scott Brown of MA threatened to vote against the measure due to the inclusion at the last second of some ~\$19B worth of fees on the financial services industry; his vote is considered crucial for passage. Fiscal Consolidation appeared as a major theme of the G20 summit with countries agreeing to cut their deficits by at least 50% by 2013 and to stabilize their debt-to-output ratios by 2016. Banks received mild concession at G20 – new capital rules can be phased in with a goal of full compliance by 2012, the real work on bank capital and the Basel III accords will come at the next G20 summit in November in South Korea.

UBS has produced a relatively optimistic view of the Australia's growth outlook due to the expected strength of our major trading partners relative to the rest of the world. The report stated:

In the past, there was not much of a difference between the growth of Australia's trading partners (TP) and the world. But now, the increased share of Australia's exports going to faster-growing emerging economies means that, even if global growth moderates over the next year or so as we expect, our trading partners will still expand at a pace similar to the last 'global boom' period of 2004-2007. Specifically, our trading partner growth is forecast to be 2%pts higher than world growth in 2010 (at 6%), and 1½%pts higher in 2011 (5%). This is a key reason for our relatively optimistic growth outlook for Australia (3.5% in 2010 and 4% in 2011). Looking further forward, we highlight an IMF paper that concludes that the higher cost of capital – due to the global financial crisis (GFC) – has had little negative impact on Australia's trend rate of growth, as it was mostly offset by a higher return to capital from strong commodity demand. Indeed, the author argues that Australia's growth potential over the medium term clearly stands out as the best among the major advanced economies. While we note the risks around European sovereign debt concerns and their potential impact on financial markets (given Australia's exposure to offshore funding needs), our much stronger linkages to the emerging markets

ultimately points to relative growth outperformance – implying the need for structurally higher interest rates, and a higher AUD, over the period ahead.

In the ‘rest of the world’ the European debt issues continues to dominate, Greek bond spreads have pushed to record-wide levels, and this in turn is weighing on other peripheral EU bonds, and risk appetite more broadly. Royal Bank of Scotland (RBS) see the direct impact of this on Australian banks’ margins and access to funding markets as being contained, but retain a preference for the resources sector. RBS said:

Although Greece has been taken out of the primary issuance market by the EU/IMF rescue package, the spreads on its bonds trading in the secondary market continue to widen. The ECB has been scaling back its direct bond purchases, and Greece’s 5yr credit default swap premium hit an all-time high of 1,037bp on Thursday. This level of protection suggests to us that the market is resigned to an eventual restructuring of its debt obligations.

What does it mean for the rest of Europe? The market’s attention now turns to Portugal, Spain and Ireland. Credit default swaps on these sovereigns have also pushed out (average 286bp), but remain within the 7 June peak of 302bp. Backstop support for these sovereigns is available in the form of the EU/IMF €750bn stabilisation fund. This in turn provides capacity for them to support their respective banks, which may face haircuts on their €111bn of Greek bonds.

And for Australia? The direct Australian market impact is centred on the banks – through margin pressure in terms of a higher cost of wholesale funds, and through valuations in the form of increased refinancing risk. We see both risks as being contained, with our credit strategist, John Manning, reporting the Australian banks being included by offshore investors in a narrow set of high quality AA-rated banks. And pricing on recent issues has hardly moved (NAB issued A\$1bn of 3yr paper this week at 85 over BBSW). However, we do maintain resources as our preferred sector, given our confidence in a continued China-led global economic recovery, and attractive discounts to NPV.

Research

Toll Holdings Limited (\$5.56) – Following the remodel of TOL’s six business divisions, Deutsche has **downgraded** to a HOLD with a price target of \$6.40.

Domino’s Pizza Enterprises Limited (\$5.30) - With recent share price movements, JP Morgan has **downgraded** to a HOLD with a price target of \$5.30.

Caltex Australia Limited (\$9.85) – Following their provision of guidance for 1H10, Deutsche has **downgraded** to a HOLD with a price target of \$10.30.