Switzer Super Report

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Oh the humanity

With the US government in shutdown mode for a week now, and a debt ceiling deadline of October 17 looming, it's only normal that we'd see predictions of a pullback for stocks. And one such forecast tips a 13% drop! I look at the arguments for and against this in my note today, as well as the Hindenburg Omen...

Also in the *Switzer Super Report,* Macquarie has risen significantly in the past few years, so James Dunn analyses whether the investment bank has run too far. Veteran investor Chris Cuffe talks about his philanthropic endeavor, fund-of-fund Third Link. Rudi Filapek-Vandyck reveals what the brokers are saying; Alumina and Retail Food Group both received an upgrade. And Penny Pryor takes a look at the Australian property market where Sydney home values surged 10%, followed by Melbourne.

Sincerely,

Peter Switzer

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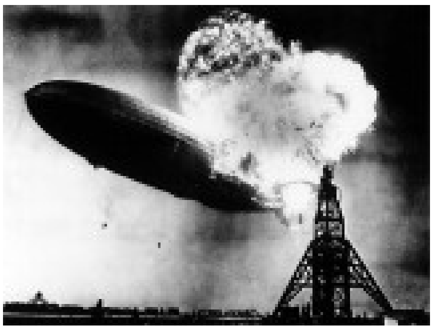

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by Peter Switzer
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T: 1300 SWITZER (1300 794 8937) F: (02) 9327 4366

Could stocks blow up 13% plus — Hindenburg-style?

by Peter Switzer

One of the great tragedies of US history was the Hindenburg disaster. Herbert Morrison made "Oh the humanity" famous as the announcer at that unforgettable event. So, could the stock market be heading for a Hindenburg moment?

Major headwinds

Before that, let me set the scene.

Sam Stovall of S&P Capital IQ is one of my favourite US experts and recently he was talking about a market analyst, who was tipping a 13% pullback in stocks. The discussion is relevant with the major headwinds, significantly in hurricane season for the Yanks, coming from Washington and the nincompoops in Congress.

Let's face it, China, Japan, the UK and even Europe look to be making a positive contribution to the world economy and global markets. Also, the US economy keeps delivering, on net, more positive signs that it is in recovery mode, but the now weeklong shutdown of non-essential government departments and the October 17 deadline on the debt-ceiling could easily rattle the market, if it was thought a genuine debt default could happen with the USA.

This would make me believe a 13% or more fall in stocks would be possible, but I still don't see it as probable.

A default just can't happen, as it would undermine investor confidence worldwide — the belief in US treasuries is that important!

The 'no default' view

So where are we with this Congress standoff?

Republican House Speaker John Boehner doesn't have a majority to pass legislation on raising the $16.7 trillion borrowing limit, without spending cut conditions attached. He is hamstrung by his Republican colleagues, who have defected to the 'Tea Party' — a bunch of conservative economic maniacs, who interpret economic theory literally like religious hardliners perceive the Bible or the Koran.

Boehner says the US was on the path to a credit default but a Tea Party pollie, Tim Huelskamp from Kansas pointed out on CNBC that the next repayment on US borrowings isn't until October 30 and then the one after that in mid-November. He argues the October 17 deadline could be passed with no default happening, and so he thinks markets know this and that's why they haven't sold off heavily.
He ruled out a default would happen and I hope he's on the money.

Moody's has also joined the debate and it doubts a default will result.

"It is unlikely that we go past October 17 and fail to raise the debt ceiling, but even if that does happen, then we think that the US Treasury is still going to pay on those Treasury securities," said Moody's CEO Raymond McDaniel.

Stovall thinks a 5% sell-off is more likely but his analysis is certainly based on the debt-ceiling issue being settled and that it would be buyer fatigue that could explain the lack of enthusiasm for stocks after the market's 25% plus gain this year in the USA.

Sell-off on the cards

On my Switzer program last night, Lance Lai of Accountancy Invest, said the charts indicate a toppy-feeling for stocks, and so a sell-off is on the cards. If the Congress adds more lead in the saddlebags, then the 13% call is possible. That said, he thinks an end-of-year rally also looks likely.

Meanwhile Gary Stone of Share Wealth Systems thinks US markets are in a sideways pattern, but a move up could be just as likely as a move down. Like Lai, he thinks the bull market will reassert itself after any sell-off. He nominated low interest rates, the history of low economic growth as a starting point for a bull market and the “don’t fight the Fed” attitude of smart investors as the prime reasons for stocks to head up, even after a pullback.

The Hindenburg Omen…

And then there is the Hindenburg Omen, which could well be telling us that Stovall is wrong and a big stock slump is on the way!

Chris Puplava of www.financialsense.com looked at this old indicator, which in a nutshell says if a market starts delivering lots of new highs and new lows, then there could be something crazy afoot. A normal bull market will generally make new highs — for the indexes and for companies — but if you get lows as well, then there could be a Hindenburg zeppelin blow up on the cards.

Puplava did a neat job to explain some odd reasons for new lows and pretty well dismissed the Hindenburg doomsday merchants around right now for being long on hot air.

“We got a cluster of Hindenburg Omens in late 2005 and yet we only saw a mild pullback—not a crash or bear market, which was confirmed by new highs still dominating new lows… However, around the cluster of Hindenburg Omens in 2007, we saw that new 52-week lows began to dominate new highs; this was the sign of a market topping and why the Hindenburg Omen carried more weight in 2007 than in 2005.”

Buying opportunity

For my part, if Congress stupidity allows a default, then I would expect a sell-off and it could be 13% plus, but I’d then repeat my usual message that it would be a buying opportunity.

I wouldn’t be saying that if there were real Hindenburg omens out there, as it is this Report’s job to tell you when it could be “get out” time.

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The return of Macquarie – has it run too far?

by James Dunn

After a difficult GFC, the turnaround on the share market by Macquarie Group Limited (MQG) – Australia's largest homegrown investment bank – over the last two years has been very impressive.

From September 2011, when it traded at levels around $23, Macquarie has now surged to close yesterday at $47.65, near its highest point since April 2010. Over the last 12 months, the stock has put on 64%; so far in 2013, the gain is 34%.

Stock Chart for Macquarie Group Ltd (MQG)

Source: Bloomberg

Round numbers mean nothing on the share market, but nevertheless there would have been quiet satisfaction at 1 Martin Place, Sydney, in September when Macquarie shares touched $50 for the first time in three years.

Cash is back

The share price performance has come about because Macquarie is back to cash generation in a big way.

As recently as FY12 (Macquarie's year ends on 31 March), the bank earned 210 cents a share, and paid a dividend of 140 cents.

For FY13, the earnings per share (EPS) was 251 cents, and the dividend was 200 cents. But for the year ending 31 March 2014, the analysts' consensus expects EPS of 305 cents a share for Macquarie, up 21.4%, and a dividend of 237.7 cents a share in FY14, up 18.9% on FY13.

FY15 is shaping up to be even better: the consensus is looking for EPS of 367.5 cents, and a dividend of 289.4 cents a share – just over double what it paid as recently as FY12. There are not many stocks around boasting that kind of turbo-powered payout growth.

New business model

What happened is that Macquarie has completely changed its business model, such that recurring revenue streams – which it did not have only two years ago – now represent almost three-quarters of group earnings.

Macquarie is now clearly split into the three "non-market facing" divisions, which are Corporate & Asset Finance (CAF), the lending and asset-finance business, Macquarie Funds (the funds management business) and the banking and financial services (BFS) business; and the "market-facing" businesses, Macquarie Securities, the Fixed Income, Currencies & Commodities (FICC) division and Macquarie Capital.

The non-market facing divisions generate the recurring income, with Macquarie Funds the star.

Macquarie too expensive?

The run-up in the share price has been effectively the market pricing-in a recovery in the earnings of the market-facing businesses, as global economic conditions recover and capital markets activity – mergers and acquisitions, (M&A), initial public offerings (IPOs) and secondary capital market raisings and the like – starts to surge. These are volatile businesses, but they have been subdued, and Macquarie is in a good position to leverage on improved activity. That is what the market expects, on the back of improving global economic data – even from Europe.

But – has Macquarie run too far?

The range of price targets for Macquarie from the brokers varies from CIMB Securities at the bearish end, at $39.85, to Credit Suisse at $55 and Deutsche Bank at $56.20. The latter pair are the only two brokers overtly positive on Macquarie – Credit Suisse rates it as 'outperform,' while Deutsche has the stock as 'buy' – while the rest, BA-Merrill Lynch, JP Morgan, UBS, Citi, RBS Morgans and CIMB Securities all rate MQG as 'neutral.' The consensus price target comes in at $47.64, pretty close to its current share price, which means that Macquarie is fully priced and yes, Macquarie has run too far.

In July, Macquarie told the market that despite write-downs (expected to come in the FICC business), the first half of FY14 would be in line with the second half of FY13 – which was a strong half. (Macquarie usually generates about 60% of its annual profit in the second half.) This implies that Macquarie should be able to deliver an interim profit of about $490 million for the half-year to September 2013.

And if the long-awaited improvement in capital markets starts to flow, then the second half of FY14 should be even stronger. For example, RBS Morgans says Macquarie stands to gain the work on six potential IPOs in the last quarter of 2013, totalling about $4.9 billion, which would boost market-facing earnings significantly. Because Macquarie generates about 63% of its earnings offshore, any earnings improvement will be augmented by a lower A$ against the US$: every 10% fall in the A$ lifts Macquarie's full-year net profit by about 6%.

(Interestingly, RBS Morgans says Macquarie is "double blessed," in that the technical and fundamental analysis concur: the broker says the uptrend in which MQG has been trading since September 2011 remains technically intact, with the first potential upside price target at $50.40, with a medium term possibility of $53.85.)

Yield play

While waiting for capital market recovery to strengthen, investors clearly have to bank on the US Congress striking a deal on the debt limit by October 17 and not allowing the US to default – because that would not be good at all for capital markets, given that it would probably plunge the US and the global economy into recession. Absent that happening, Macquarie is trading on decent yields – although the large proportion of offshore earnings means that 40% franking is about the best the bank will be able to do on its dividends in FY14 and FY15.

On FY15 expectations, Macquarie is trading at a 6% nominal yield, which for an SMSF in accumulation mode also represents 6%, while to an SMSF in pension mode the equivalent yield is about 7.08%. That is a healthy yield to sit on while you wait for the leverage to better global markets that Macquarie represents.

The caveat is that a major market shock that hammers market confidence and sends recent asset price rises into reverse would also hit the MQG share price. And since 2007, all investors should know that such things are always possible.

Chris Cuffe on Third Link

by Fundie's Favourite

What is it?

Third Link is a professionally managed fund-of-fund and all fees received by Third Link Investment Managers from managing the fund's investments, net of expenses incurred, go to support the non-profit sector.

It's an interesting little product. It's an innovative type of thing; it's very hard for anyone else to do. Apart from having the expertise, you needed to be pretty well-known.

How is it going?

It kicked off in the first half of 2008 and also another milestone is that it's just passed giving $2 million away now [in total] to charity and that obviously increases every day as the fund size increases. Funds under management are $60 million.

Who are the main investors?

It seems to be, if I was to guess, primarily SMSFs, and also there are some private ancillary funds. It's suitable for anybody.

How do you select fund managers?

If you actually looked at how I select funds and combine them, I would probably completely fail all the normal boxes that an institutional manager mixing managers would tick.

I think the engineers behind most fund-of-funds way over-engineer and end up engineering managers right back to an index. It's not surprising that, to my knowledge, every fund-of-fund has underperformed the index.

The managers I'm after are the ones who are demonstrably trying to create outperformance…not benchmark huggers. I'm happy to judge them over five-year periods. I don't care what they do over the one, two years.

I can seriously invest for the long term and I don't care what it does in the short term. I couldn't care less how it does against others. All I care about is on an individual manager basis, I can look at their performance and [they've outperformed].

There are not a lot of managers who I use really. I don't think there are many managers out there in Australia swinging the bat [for active management].

What's the structure?

I invest in an existing fund of each of these managers.

What happens at the end of each quarter or half year is I just get a cheque back from the various managers rebating fees.

Originally I created it as a diversified growth fund, but around 18 months ago I changed the thing so it was just 100% Aussie equities, and I did that because I found over time that some wealth advisers were saying they would use a sector specific fund. But it was very successful when it was a diversified growth fund.

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Buy, hold and sell – what the brokers say

by Rudi Filapek-Vandyck

The lead up to the long weekend saw stockbroker analysts thinking about other things, rather than individual company ratings. Alumina led the upgrades, with Leighton and ResMed heading the downgrades, the latter largely because it has met price targets.

Perhaps the most important news from the week past is that upgrades to earnings forecasts have become larger. This includes two major banks (NAB and ANZ), which both had their earnings forecasts lifted by more than 6%.

In the good books

CIMB upgraded Alumina (AWC) to Outperform from Neutral, following a study into structural cost increases across the world's mining sector.

Upgrades				
Code	Company	Old Rating	New Rating	Broker
AWC	Alumina	Neutral	Buy	CIMB Securities
BHP	BHP Billiton	Neutral	Buy	CIMB Securities
CSL	CSL	Buy	Buy	UBS
RFG	Retail Food Group	Neutral	Buy	UBS

For Australian investors, the key conclusions are:

- new supply for most commodities is operating at relatively high costs, providing support for existing producers; and
- in Australia production, costs in coal and iron ore are poised to surprise to the downside.

For Alumina Ltd, the result has been a boost to valuation/price target to $1.40 from $1.21 and this has triggered an upgrade in rating too; to Outperform from Neutral.

UBS upgraded Retail Food Group (RFG) to Buy from Neutral, having lifted their earnings forecasts for coming years. This has led to an increase in the stockbroker's price target, to $4.70 from $4.40, and triggered an upgrade in rating to Buy from Neutral. UBS analysts have taken a favourable view on the growth profile, arguing the profile has transitioned from "average growth at discount value" to "above average growth at average value". Bottom line: shareholders should see further rewards even after the re-rating that has already taken place. The company is generating enough cash to maintain the current 5% yield in dividends, state the analysts. On top of this, the broker sees further bolt-on acquisitions on the horizon.

In the not so good books

Citi followed news about the allegations of impropriety in Leighton Holdings (LEI) international business, and downgraded Leighton to Sell from Neutral. Leighton has made improvements to risk management and governance but investor concerns remain heightened. Hence, the broker has lowered the target price to $15.35 from $18.97, applying a 10% discount to valuation on the increased risk to offshore earnings and cash collection. The rating is downgraded to Sell from Neutral, as the expected total return is negative 7%.

Downgrades				
Code	Company	Old Rating	New Rating	Broker
5	K & S Corporation	Buy	Neutral	Macquarie
6	K & S Corporation	Buy	Sell	Deutsche Bank
7	Leighton	Neutral	Sell	Citi
8	Matrix Composites & Engineering	Neutral	Sell	JP Morgan
9	Oil Search	Neutral	Sell	Citi
10	Qantas	Buy	Neutral	CIMB Securities
11	Resmed	Buy	Neutral	UBS

JP Morgan downgraded Matrix Composites & Engineering (MCE) to Underweight from Neutral, saying that there are too many near-term risks in the order book. The company's order book was at historical lows at the FY13 result and there's been no major contracts announced since August. Earnings forecasts have been cut to reflect the difficulties building the order book in the near term without sacrificing margin. The price target is reduced to 65c from 95c.

Qantas (QAN) was downgraded to Neutral from Outperform by CIMB, as the August traffic numbers show domestic market capacity growth is moderating and Virgin Australia (VAH) is gaining ground on Qantas in the domestic market. For Qantas, CIMB believes the earnings risk is shifting to the international segment, as capacity in that area is accelerating from a number of foreign carriers. Hence, the rating is downgraded to Neutral from Outperform and the price target is reduced to $1.49 from $1.73. No earnings changes are made at this stage and the broker continues to prefer Qantas over Virgin on valuation. It's just that in the short term, concerns over the competitive landscape are overshadowing the positives.

Although lifting the price target, UBS downgraded ResMed (RMD) to Neutral from Buy following a recent rally in the stock price. The three-year re-bidding of Round 1 of the US Medicare pricing has been completed and there has been a bounce in price expectations. UBS re-bid price estimates are about 11% higher. UBS notes the nine major cities that took part in the competitive bidding process three years ago affect about 1% of ResMed's revenue. For UBS, the direction of the price signal is most important and indicates a more rational stance on pricing. There has been change in valuation assumptions but, with the recent rally in the stock price, the rating moves down to Neutral from Buy. The price target is raised to US$53.01 from US$50.50. In Australian dollar terms, this is raised to $5.64 from $5.52.

Earnings forecast

Order	Company	Previous EF	New EF	Change	Recs
Positive Change Covered by > 2 Brokers					
1	AQG	11.226	31.108	177.11%	6
2	IPL	18.430	21.841	18.51%	8
3	PRU	0.813	0.953	17.22%	7
4	DLX	23.586	27.586	16.96%	7
5	BTT	20.873	22.938	9.89%	4
6	TNE	8.775	9.600	9.40%	4
7	ORI	161.568	176.050	8.96%	8
8	AWE	7.871	8.457	7.45%	6
9	NAB	252.838	269.925	6.76%	8
10	ANZ	230.713	244.775	6.10%	8
Negative Change Covered by > 2 Brokers					
1	AWC	0.016	-0.010	-162.50%	8
2	GBG	1.186	0.386	-67.45%	5
3	QBE	96.191	94.285	-1.98%	8
4	CTX	147.757	146.186	-1.06%	7
5	HZN	4.187	4.147	-0.96%	4
6	SFR	80.938	80.255	-0.84%	8
7	UGL	70.938	70.563	-0.53%	8
8	ASX	200.388	199.513	-0.44%	8
9	ALQ	55.438	55.238	-0.36%	8
10	NUF	37.349	37.224	-0.33%	8

The above was compiled from reports on the FNArena database, which tabulates the views of eight major Australian and international stock brokers: BA-Merrill Lynch, CIMB, Citi, Credit Suisse, Deutsche Bank, JP Morgan, Macquarie and UBS.

Sydney property prices up by almost 10%

by Penny Pryor

Interest rates remained on hold last week, but low rates are still fuelling activity in the housing market, despite a disappointing drop in residential building approvals for August, released last week by the Australian Bureau of Statistics.

The number of residential building approvals fell by 4.7% in August, following a jump of 10.2% in July. CommSec economist Gareth Aird said the magnitude of the August fall was disappointing.

But house prices, particularly on the east coast and most obviously in Sydney, continue to rise. Sydney has shown an almost 10% increase in home values for the year to date, compared to 7.1% for Melbourne and 5.9% for Perth, according to RP Data (see table 1 below). The combined five capitals have seen a year to date increase of 6.7% and an annual rise of 5.5%.

Table 1: capital city home value changes

	Weekly Change	Monthly Change	Yr to date Change	Annual Change
Sydney	0.8%	2.3%	9.9%	7.9%
Melbourne	0.3%	2.3%	7.1%	5.4%
Brisbane	-0.4%	-0.3%	1.5%	1.0%
Adelaide	-0.4%	1.0%	0.9%	-1.0%
Perth	0.7%	-0.1%	5.9%	7.7%
Combined	**0.4%**	**1.6%**	**6.7%**	**5.5%**

**Brisbane results are for the combined Brisbane and Gold Coast*
Source RP Data

The long weekend brought plenty of auction activity, with RP Data reporting 1,483 auctions scheduled across the country in capital cities, compared to 1,243 the previous week. The preliminary capital city weighted average clearance rate fell to 69.8%, compared to 73.5% the week before.

It was Sydney's turn to be affected by footy fever on the weekend, as auction activity there was lower, with just 256 properties listed for auction, compared to 585 the week before. The clearance rate was still strong at 81.8% (see table 2 below) and Melbourne recorded a solid 75%.

Table 2: This Saturday, 5 October 2013

	Clearance Rate%	Number Listed	Number Reported Auctions	Number Sold	Number W/drawn	Total Value Sold ($million)	Auction Median Houses	Auction Median Units
Sydney	81.8%	256	206	180	14	$152.2	$875,000	$600,000
Melbourne	75.0%	732	521	395	6	$222.9	$680,500	$475,000
Adelaide	77.3%	32	21	17	1	$8.3	$615,000	SNR
Brisbane	52.2%	57	23	12	0	$7.7	$730,500	SNR

Source: APM

The week before saw a revised clearance rate of 80% for Sydney and 70.7% for Melbourne. The median house price for Sydney was $920,000 and that compares to $842,500 recorded a year ago (see table 3 below). AMP Capital Investors head of investment strategy and chief economist, Shane Oliver, says the increase in house prices is providing a boost to household wealth.

"Australian economic data added to confidence that rate cuts, helped by the confidence boost from the change in Government, are getting traction and that economic growth is bottoming," he said in his weekly report.

Table 3: Saturday 28 September, 2013

	Clearance Rate%	Number Listed	Number Reported Auctions	Number Sold	Number W/drawn	Total Value Sold ($million)	Auction Median Houses	Auction Median Units
Sydney	80.0%	585	524	445	32	$398.6	$920,000	$679,000
Melbourne	70.7%	44	38	29	3	$16.1	$702,500	SNR
Adelaide	70.0%	21	18	14	2	$7.7	$562,000	SNR
Brisbane	44.9%	77	64	31	5	$18.5	$726,000	SNR

Source: APM

This time last year, auction clearance rates were still unimpressive, with Sydney recording a clearance rate under 60% and Melbourne just over 60% despite over 500 properties being listed (see table 4 below).

Table 4: Saturday 6 October 2012

	Clearance Rate%	Number Listed	Number Reported Auctions	Number Sold	Number W/drawn	Total Value Sold ($million)	Auction Median Houses	Auction Median Units
Sydney	58.8%	413	353	231	40	$176.7	$842,500	$654,000
Melbourne	61.1%	503	277	174	8	$96.6	$578,500	$410,000
Adelaide	54.5%	59	51	30	4	$15.3	$459,000	SNR
Brisbane	50.9%	67	54	28	1	$10.6	$547,500	SNR

Source: APM

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Did you know?

In this month's *Switzer Super Report* webinar, Paul Rickard and I covered everything from the current situation in the US and how it could affect your investments, to property strategies and local stock insights. Watch this month's webinar here, and please join us at our next webinar in November!