Switzer Super Report

Monday 26 October 2015

Things have changed

It's just over a week until Cup Day, but there's another important meeting on the first Tuesday in November – the Reserve Bank board meeting! I have changed my mind on the cash rate – I think the RBA should cut – it would help our economy, and also our stocks, and I explain how in today's note.

Paul Rickard reveals he has been wrong on Telstra, but its fully franked dividend for FY16 puts it in the buy zone. And if you are thinking about a US stock for your portfolio, Chris Demasi from Montgomery Investment Management says that Amex shares are trading at a discount.

In *Buy, Sell, Hold – what the brokers say* this week, brokers upgraded Telstra, but downgraded a couple of mining companies. And in *Super Stock Selectors*, the energy sector and Lend Lease were among the likes.

Sincerely,

Peter

Peter Switzer

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I've changed my mind. Bring on a rate cut for the sake of stocks!

by Peter Switzer

Until the banks decided to raise both home and investor loan rates, after already being forced a few months ago to raise rates to investors, I thought the Reserve Bank (RBA) would and should keep the cash rate on hold at 2%. However, as the Bob Dylan song goes: "People are crazy and times are strange, I'm locked in tight, I'm out of range, I used to care but things have changed".

Certainly, I think times are strange and that's why I have changed. I was locked in tight on no rate change needed for some time but this David Murray/APRA pressure on banks has made it all crazy so I want a Cup Day rate cut.

I will look at the economics of my change of heart on rates later but let me throw in that lower rates will bring the dollar down and help stocks go higher, so there is an added reason for me to become a rate-cutter.

You might have missed this but I haven't as I have been a big advocate of buying the dips, but since Glencore Tuesday, when my media colleagues were dragging out their "market meltdown" headlines, the S&P/ASX 200 index is up 8.8%!

That's nearly 9% since September 28 — in a bit over three weeks!

And this is a nice prelude to a period where the stock market has a great inclination to head higher over November and especially December.

Right now the global economy is coping with the slow response of the Eurozone and Japan to quantitative easing or QE, China's need to cut rates to stimulate growth and the US economic recovery being taken down a notch as the greenback rises.

The response of central banks is to stick with low interest rates and stock markets like that sort of thing provided that there is a belief that economic growth is coming and deflation is not on the way. Right now, the majority of investors and key stock market influencers believe the optimistic story and that's why we're up 8.8% in three weeks.

Christopher Swan, a strategist at UBS in the US, is a little surprised at the big post-Summer market rebound but, more importantly, he thinks it can last! He points out that "the MSCI All Country World index, the broadest gauge of global equities, has jumped 7% since sentiment suddenly improved on September 29", so our market has gained from great global optimism but has done a little better.

He says purchasing managers indexes, earnings and economic data in the US, Europe and Japan should underpin positivity.

But I love this UBS view on China: "We also believe the Chinese economy has the willingness and the tools to avert a dramatic slowdown in growth. Its budget is in surplus, it still has reserves of well over $3 trillion, and its one-year interest rates are at 4.6%, leaving room for the country to ease monetary policy" (CNBC).

His final point is more telling and relevant to my argument and here it is: "Lastly, all major central banks are aggressively promoting growth. We see little danger that inflation will force them to remove the punch bowl. And equity valuations are nowhere near bubble territory. The MSCI World index is valued at less than 16 times predicted earnings versus an 18-year average of 17 times."

Swan thinks emerging economies and those selling commodities have done better recently because they were the most battered before the rebound but he thinks they might have had their big spurt.

We often run with emerging economies because of our commodities link and so another rate cut from the RBA (just as the big four banks are raising rates, which could easily slow up our economic recovery), makes a lot of appeal.

AMP's Shane Oliver says if the RBA cuts by 25 basis points then a bank like Westpac might only pass on a 5 basis points cut, effectively pocketing the 20 basis points it wants for having to place more shares to please APRA. I hope he is right but we are in a historically unique period, but I hope Shane is right.

If the RBA does not cut on the first Tuesday in November, then I think it will slow down our economic recovery. If the RBA cuts, it could help stocks as it would raise the fair value calculation for the stock market, which has a tendency to influence the market.

I'm punting on a rate cut on Cup Day, so I hope Glenn Stevens puts me on a winner, which we all will share in when it creates more economic growth and helps stocks head higher!

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Telstra is in the buy zone

by Paul Rickard

I have been wrong on Telstra. I thought it was a "buy in dips" type stock when I wrote back on 17 August to "hang on to your Telstra". Since then, it has performed rather poorly.

In fact, it has been one of the poorer performers on the market over the last eight months. Since rising rapidly at the start of the year to peak at $6.70 on 6 February, it has fallen away. Last Monday, it touched $5.28, before closing the week strongly at $5.58.

Telstra Share Price – 24/10/14 to 23/10/15

Source: Yahoo!7 Finance, 26 October 2015

So, what's gone "wrong" with Telstra?

"Wrong" might be too strong a word, but let's have a look at what has happened at Telstra over the last few months.

Firstly, while Telstra marginally beat guidance and analysts' expectations for its full year results, the second half pointed to some challenges ahead. In the important mobiles market, Telstra's rate of growth in new mobile services slowed from 366,000 services in the first half to 298,000 services in the second half. While Telstra was able to maintain its EBITDA margin, average revenue per unit fell by $0.63 due to higher data allowances and lower excess data rates.

With Vodafone and Optus investing in their networks and fighting harder to win customers, the lead Telstra has had in mobiles is under attack. Telstra grew mobile sales revenue by 10.2% in FY15 – achieving this rate going forward could be more difficult.

And while not correlated in any way, Telstra's mobile growth challenges have come to the forefront as the same time as some of the gloss has come off Apple. Apple's shares are off 10% from their high of US$134.54.

Apple Share Price – 24/10/14 to 23/10/15

Source: Yahoo!7 Finance, 26 October 2015

Telstra also gave the market a bit of a scare back on 28 August when it went on the record to comment on speculation of a wireless joint venture in the Philippines with San Miguel Corporation. Given Telstra's track record on offshore investments, this wasn't initially seen as a positive. Not a peep since, however.

And as a defacto yield stock for many investors, Telstra's share price has also responded to a cheapening in bank stocks. With the some of the major banks paying dividend yields around 6%, Telstra's forecast yield of 5.3% at a share price of $6.00 was interesting, but not compelling.

There have also been 2 ACCC rulings that have impacted Telstra since it announced its result in

August. The first, relating to wholesale prices for mobile terminating access services, shouldn't have any material impact on Telstra's EBITDA in FY16, although it will result in a reduction in reported revenue of $350m. The second, to do with access for fixed line services, will knock EBITDA in FY16 down by $80m.

Finally, there has been the impact of a new CEO in Andrew Penn, and a number of chartists have identified technical reasons to sell Telstra. And of course, the analysts remain largely negative on Telstra.

The Brokers

The Brokers have never really liked Telstra since it became the favoured stock of SMSFs and others seeking tax-advantaged income, and the Telstra Board responded by putting so much effort into a commitment to maintain (and potentially increase over time) the dividend. In fact, I can't remember a time when the analysts were bullish on Telstra.

They see Telstra as a fully valued, very low growth defensive stock, which is potentially vulnerable to competition. Free cash flow is being used to pay dividends, leading to a dividend payout ratio in the nineties.

According to FN Arena, the Brokers are remaining mildly negative on the stock. The consensus target price of $5.66 is 1.4% above Friday's closing price of $5.58.

Broker	Recommendation	Target Price
Citi	Neutral	$5.72
Credit Suisse	Underperform	$5.65
Deutsche Bank	Hold	$5.46
JP Morgan	Neutral	$5.62
Macquarie	Neutral	$5.85
Morgan Stanley	Equal-Weight	$5.75
Morgans	Hold	$5.93
UBS	Sell	$5.30

How to play

At its AGM, Telstra reaffirmed financial guidance for FY16. This is:

- Mid single digit growth in total income;
- Low single digit growth in EBITDA;
- Free cash flow of $4.6bn to $5.1bn.

They also went out of their way to talk about how they are not just a phone company, but rather their aspiration to become a "world class technology company", and the investments they are making in video, cloud and e-health.

Barring some "black swan event", Telstra shareholders can have a high degree of confidence that they will get a fully franked dividend of 31.5c per share, maybe even 32.0c per share, in FY16. At $5.58, Telstra is trading on a fully franked yield of 5.64% to 5.73%.

This puts Telstra in the buy zone. It is not a screaming buy, unless you buy the dream that Telstra can become a world-class technology company. I am not there yet – and nor is the market – although I do think some of the initiatives have promise, and to be fair to the Telstra team, it has come a long way over the last five years. However, still a buy in dips strategy.

Telstra is due to hold an Investor Day for analysts on Thursday (you can also watch it live on their website from 9.15am). It will be interesting to see if there is any change of sentiment from the analysts post the briefing.

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Buy, Sell, Hold – what the brokers say

by Rudi Filapek-Vandyck

In the good books

QBE INSURANCE GROUP LIMITED (QBE) Upgrade to Buy from Neutral by UBS B/H/S: 6/2/0. UBS has revisited its expectations for QBE and has become less negative on the cyclical trends in both personal and commercial lines in Australia. Although the company still faces some unique challenges the broker believes it is the most attractive exposure across the general insurers. UBS upgrades to Buy from Neutral. Target is steady at $14.50.

TELSTRA CORPORATION LIMITED (TLS) Upgrade to Neutral from Underperform by Macquarie B/H/S: 0/6/2. Telstra has copped some selling recently on concerns over competition and uncertainty over the company's investment strategy, Macquarie notes. The broker nevertheless sees this as priced in and believes the macro backdrop remains broadly supportive for defensive stocks. The sell-off has also pushed up Telstra's dividend yield. Ahead of the company's investor day on Oct 29, Macquarie has upgraded to Neutral. Target unchanged at $5.85.

Upgrades

Order	Company	New Rating	Old Rating	Broker
1	QBE Insurance Group	Buy	Neutral	UBS
2	Telstra Corporation	Neutral	Sell	Macquarie

In the not-so-good books

GRANGE RESOURCES LIMITED (GRR) Downgrade to Underperform from Neutral by Macquarie B/H/S: 0/1/2. Grange saw better than expected prices in the September quarter and lower costs, but sales were weaker and inventory build greater than Macquarie expected, while working capital appears to have increased significantly. The result is a $10m drop in the company's cash balance. Grange is the only iron ore producer under coverage to have seen a fall in cash balance in the quarter, Macquarie notes. Downgrade to Underperform, target falls to 9c from 11c.

PERSEUS MINING LIMITED (PRU) Downgrade to Neutral from Outperform by Macquarie B/H/S: 2/4/0. Perseus' September quarter production was below Macquarie's forecast on lower Edikan grades but met the lower end of the guidance range. Costs were lower than expected. Cost reductions provide a positive trade-off against what now look like lower grades ahead after a sterling FY15, the broker suggests. But the company has introduced some uncertainty in deciding to look at self-funding Sissingue rather than borrowing as originally planned. Macquarie thus downgrades to Neutral. Target falls to 40c from 48c.

Downgrades

Order	Company	New Rating	Old Rating	Broker
1	Asciano	Sell	Buy	Credit Suisse
2	BHP Billiton	Neutral	Buy	Citi
3	Grange Resources	Sell	Neutral	Macquarie
4	Mantra Group	Neutral	Buy	UBS
5	Newcrest Mining	Neutral	Buy	Morgans
6	Newcrest Mining	Neutral	Buy	Citi
7	Perseus Mining	Neutral	Buy	Macquarie
8	Regis Resources	Neutral	Buy	Citi
9	Regis Resources	Sell	Neutral	Credit Suisse
10	Regis Resources	Sell	Neutral	Deutsche Bank

Earnings Forecasts

Order	Symbol	Company	New EF	Previous EF	Recs
Positive Change Covered by > 2 Brokers					
1	PDN	Paladin Energy	-0.40	-0.21	5
2	ORE	Orocobre	-14.90	-11.75	3
3	ARI	Arrium	1.01	0.86	7
4	RIO	Rio Tinto	342.09	305.40	8
5	RRL	Regis Resources	16.40	14.65	8
6	API	Australian Pharmaceutical Industries	8.50	7.76	4
7	DUE	Duet Group	8.30	7.88	7
8	EVN	Evolution Mining	16.96	16.62	6
9	NWS	News Corp	66.93	65.71	6
10	BAP	Burson Group	16.90	16.70	3
Negative Change Covered by > 2 Brokers					
Order	**Symbol**	**Company**	**New EF**	**Previous EF**	**Recs**
1	PRU	Perseus Mining	1.38	0.00	6
2	VIT	Vitaco Holdings	4.70	7.95	3
3	S32	South32	3.72	5.67	7
4	ILU	Iluka Resources	23.96	30.34	7
5	BCI	BC Iron	-3.18	-3.90	3
6	NCM	Newcrest Mining	57.36	67.75	8
7	BHP	BHP Billiton	72.75	81.08	8
8	DLS	Drillsearch Energy	7.99	8.77	6
9	GRR	Grange Resources	2.33	2.50	3
10	STO	Santos	16.73	17.61	8

FNArena 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.

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Super Stock Selectors – energy sector and LLC

by Staff Reporter

This week, Michael McCarthy from CMC Markets is a fan of the entire energy sector.

He says the $7.1 billion foreign takeover bid for Santos, an agreed merger between Beach Energy and Drillsearch, and BHP's purchase of acreage in Western Australia and the Gulf of Mexico are "all signs we've seen the bottom in energy stocks."

His top picks from the sector are OilSearch (OSH) and Woodside Petroleum (WPL).

Managing partner at Morgans, Raymond Chan, likes property and infrastructure company Lend Lease (LLC) as it appears oversold.

Also in the likes list this week is Fisher and Paykel Healthcare (FPH).

"After a period of consolidation from March this year to last week, Fisher and Paykel Healthcare's share price has broken out of an ascending triangle to a new all-time high, which is a bullish advance," says Gary Stone of Share Wealth Systems.

Switzer Super Report co-founder, Paul Rickard, likes Telstra (TLS) below $5.50. Read his full analysis of the company in today's report here. He thinks Challenger (CGF) has had a great run and might be due for some profit taking.

Also in the dislikes list is free to air broadcasting network, Ten Network Holdings (TEN), along with gold mining company Newcrest (NCM).

"The ECB announcement is a positive for gold, yet prices fell," says McCarthy.

"This points to weakness and potentially further falls. This could see a pullback in NCM to support between $11 and $12."

Expert	What stock I like	What stock I don't like
Raymond Chan, managing partner, Morgans	Lend Lease Group (LLC)	Ten Network Holdings (TEN)
Elio D'Amato, CEO Lincoln Indicators	Harvey Norman Holdings Limited (HVN)	Transurban Group (TCL)
Tony Featherstone, financial journalist	4 agribusiness stocks for the long term - Incitec Pivot (IPL), Nufarm (NUF), Rural Funds Group (RFF), Lindsay Australia (LAU)*	
Michael McCarthy, Chief Market Strategist, CMC Markets	The whole energy sector - Oil Search (OSH) and Woodside Petroleum (WPL) in particular.	Newcrest (NCM)
Paul Rickard, cofounder of the *Switzer Super Report*	Telstra (TLS) at lower levels.	Challenger (CGF)
Gary Stone, founder of Share Wealth Systems	Fisher and Paykel Healthcare Corp (FPH)	Greencross (GXL)

**SSR on 22 October 2015*

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Don’t leave home without Amex?

by Christopher Demasi

The iconic American Express Centurion Card, made from anodized titanium, etched by laser, with limitless spending capability and dedicated concierge service commands a premium annual fee that runs in the thousands and has remained elusive for all but the privileged few individuals. So it is with great irony that American Express shares are currently trading at a discount, available to any investor who is looking for a bargain.

Founded in 1850 as an express mail business, today “Amex” is a global credit and charge card issuer and payments network. Last year over US$1 trillion was spent on more than 100 million American Express-badged cards around the world. In the US, where around two thirds of Amex billings take place, the company operates the third largest card network behind giants Visa and Mastercard, capturing a quarter of the market for spending on plastic.

Such enormous scale belies Amex’s unique asset: its closed loop network. Lured by a superior rewards program and strong brand Amex’ card member base is both large and valuable. On average, an Amex customer spends more than triple a Visa or Mastercard cardholder each year and knows they can use their card with almost every merchant they want to. At the same time, merchants are willing to accept Amex cards and pay more for the privilege in order to access such important potential customers. This creates a self-reinforcing spend-centric cycle, a “chicken-and-egg” scenario that is almost impossible to replicate and becomes even more impenetrable as it expands.

Amex’s uniqueness also extends to its revenue model. Like Visa and Mastercard, Amex earns fees from merchants every time a customer swipes their card to make a purchase. Like a bank, Amex also lends to certain cardholders and earns interest on these balances. Yet the combination of high fees and interest income, along with an affluent customer base that rarely defaults, means that American Express is able to earn very high returns on the capital it must retain to support its lending operations. When most card issuers struggle to make double-digit returns on equity, Amex has easily exceeded the company target of 25%.

As the world transitions from “paper to plastic”, Amex is positioned well to capture the growing volume of spend on cards and electronic forms. Today payment forms other than cash account for just 20% of global payment volumes, despite the apparent ubiquity of credit cards in wallets and online accounts. This structural shift in the way the world pays is likely to support Amex billings growth of up to 10% annually for many years to come.

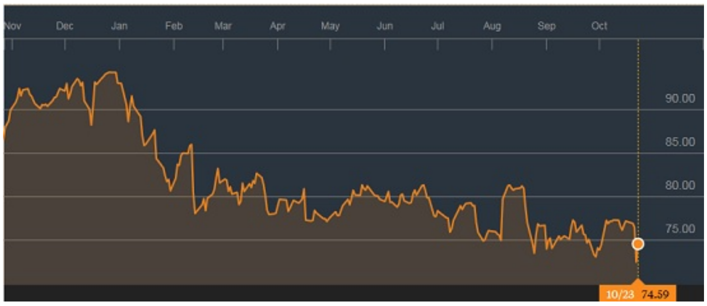
And yet a privileged business model, with high returns and lofty growth prospects has not been rewarded with a premium market rating. Following announcement of quarterly earnings this week, the price of Amex’ shares fell 5% to $72.50 representing a forward PE multiple of 14x. Indeed, a meaningful discount to the PE multiple rating of the broader US equity market, which sits at 17x.

It is likely that the market has become overly concerned by a raft of recent issues, which have been something of a perfect storm for the company this year. In February, Costco decided not to renew its exclusive relationship with Amex in the US following a similar decision in Canada. The large retailer accounted for 8% of spend on Amex cards and 20% of its global loan balance, but margins were low and management intend to deploy resources in higher returning pursuits.

At around the same time, the US Department of Justice ruled that Amex should allow merchants to steer their customers to other payment forms and away from the higher charging Amex card, even if the ability to pay with Amex brought the customers to the store in the first place. So far this has had no impact on customer behaviour. And while the long-term outlook for spending looks robust, the near term is susceptible to an uneven global economic outlook. All the while, management continues to invest in the brand and expanding Amex's technological capabilities to serve its card members and merchants in the network.

Investors who are willing to see through a transition period for Amex in the next 12 months are likely to reap rewards of their own. Not through premium rewards points, rather the return of a premium rating for an exceptional business that has lost the market's favour for now.

American Express Co (AXP: NYSE)



Source: *Bloomberg, 26 October 2015*

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