Switzer Super Report
Advice you can trust

Thursday 26 May 2016

# May moves on

There's not long left in the month, and we haven't really seen a 'sell in May' story this year. Charlie Aitken believes it prudent, however, to be prepared for volatility in global and domestic equities and buy high quality stocks later this year. Also in the *Switzer Super Report*, Tony Featherstone looks at local star performers and compares them with overseas stocks in the same sector, while Gary Stone looks at what the charts are saying about the ASX 200.

In this week's *Professional's Pick,* Sean Fenton analyses Sirtex Medical, where he sees value and more. Plus in *Buy, Sell, Hold – what the brokers say*, Westpac and Wesfarmers were in the good books.

Sincerely,

Peter Switzer

## Inside this Issue


Pick your dividend targets for the pullback
by Charlie Aitken
02



switzersuperreport.com.au

Switzer Super Report is published by Switzer Financial Group Pty Ltd AFSL No. 286 531
36-40 Queen Street, Woollahra, 2025
T: 1300 SWITZER (1300 794 8937) F: (02) 9327 4366

*Important information: This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. For this reason, any individual should, before acting, consider the appropriateness of the information, having regard to the individual's objectives, financial situation and needs and, if necessary, seek appropriate professional advice.*

# Pick your dividend targets for the pullback

by Charlie Aitken

I believe it will prove prudent to be prepared for volatility in global and domestic equities to rise over the next few months. That means have some cash aside to buy high quality growth and yield stocks at lower prices in August.

There is clearly now going to be debate about when the Fed next raises the Fed Funds Rate (FFR) by 25bp. Current expectations see a 30% chance of a June rate hike, but I tend to think they will rise to 50% over the weeks ahead and the June meeting is “live”.

To my way of thinking, the prospects of the FFR rising from 0% a few weeks ago to my forecast of 50% by next week will lead to basic profit taking that isn’t US dollars.

I expect to see the US dollar Index (DXY) rally, commodities fall, commodity currencies fall, short-dated bond prices fall and equity indices fall, remembering the rally from February lows was all driven by the perception the Fed had moved to the sidelines, which saw the US dollar fall (and everything else rally). That view was too dovish and a more hawkish Fed will drive profit taking, where profits are to be taken.

This is a good thing for those of us holding cash, but particularly in Australia, where any globally driven pullback in equities will provide excellent opportunities in a country where the cash rate is heading the other way, down. There could be a great buying opportunity in the right Australian stocks AHEAD of the full year dividend season in August and ahead of the next RBA rate cut.

Let’s be clear, the RBA has fired a shot and will fire another as Australia joins the global currency devaluation war.

The recent commentary over the last few months had suggested that the RBA was comfortable with a rebalancing of economic growth, driven by a strong housing sector and a falling Australian dollar. As such, the majority of economists interpreted monetary policy settings as appropriate.

The incumbent view changed abruptly, however, when the RBA unexpectedly cut the cash rate to 1.75% earlier this month.

Clearly, the lower-than-expected CPI data forced a dramatic change in the RBA’s monetary policy outlook. As the chart below shows, ABS data revealed Q1 16 underlying inflation slowed to just 1.55% pa, compared to expectations of 1.95% pa. This was the weakest core inflation growth on record and well below the 2-3% pa medium term inflation range targeted by the RBA.


Following the CPI data, the RBA slashed its medium term inflation forecasts, with the release of the quarterly Statement of Monetary Policy (SoMP).

As the chart below shows, the RBA previously forecast underlying inflation at 2% to June 2016, before rising to 2.5% (middle of the range) by Dec 2016 and remaining at that level out till June 2018.

**Table 6.1: Output Growth and Inflation Forecasts(a)**
Per cent

| | Year-ended | | | | | |
|---|---|---|---|---|---|---|
| | Dec 2015 | Jun 2016 | Dec 2016 | Jun 2017 | Dec 2017 | Jun 2018 |
| GDP growth | 2½ | 2–3 | 2½–3½ | 2½–3½ | 2½–3½ | 3–4 |
| CPI inflation | 1.7 | 1½ | 2–3 | 2–3 | 2–3 | 2–3 |
| Underlying inflation | 2 | 2 | 2–3 | 2–3 | 2–3 | 2–3 |
| | Year-average | | | | | |
| | 2015 | 2015/16 | 2016 | 2016/17 | 2017 | 2017/18 |
| GDP growth | 2½ | 2–3 | 2–3 | 2½–3½ | 2½–3½ | 2½–3½ |

(a) Technical assumptions include A$ at US$0.72, TWI at 62 and Brent crude oil price at US$35 per barrel; shaded regions are historical data
Sources: ABS; RBA

The next chart shows the dramatic SoMP downgrades, with the June 2016 forecast revised down from 2% to 1.5% and Dec 2016 from 2.5% to just 1.5%. In the following two years, inflation is forecast to rise to 2% by June 2017 and remain at that level out to June 2018, which is down from 2.5% previously.

**Table 6.1: Output Growth and Inflation Forecasts(a)**
Per cent

| | Year-ended | | | | | |
|---|---|---|---|---|---|---|
| | Dec 2015 | Jun 2016 | Dec 2016 | Jun 2017 | Dec 2017 | Jun 2018 |
| GDP growth | 3 | 2½–3½ | 2½–3½ | 2½–3½ | 2½–3½ | 3–4 |
| CPI inflation | 1.7 | 1 | 1–2 | 1½–2½ | 1½–2½ | 1½–2½ |
| Underlying inflation | 2 | 1½ | 1–2 | 1½–2½ | 1½–2½ | 1½–2½ |
| | Year-average | | | | | |
| | 2015 | 2015/16 | 2016 | 2016/17 | 2017 | 2017/18 |
| GDP growth | 2½ | 2½ | 2½–3½ | 2½–3½ | 2½–3½ | 2½–3½ |

(a) Technical assumptions include A$ at US$0.75, TWI at 62.5 and Brent crude oil price at US$47 per barrel; shaded regions are historical data
Sources: ABS; RBA

Make no mistake. This represents a very significant change for a central bank. It's worth noting that underlying inflation is not forecast to reach the bottom of the RBA's target range of 2-3% pa until June 2018. More importantly, the revised forecasts reflect the latest rate cut and market pricing of a further cut this year.

**The importance of the RBA downgrades should not be underestimated. The SoMP inflation revisions virtually ensure at least another rate cut and maybe even more. It now appears very likely that the deflationary tide from Japan and Europe has washed onto Australian shores.**

Unsurprisingly, the subsequent fall in domestic long bond yields has reflected the dramatic change in the RBA's inflation projections. The benchmark 10-year Australian government bond recently fell to an all-time low of 2.20%. This compares to 2.55% prior to the RBA's rate cut just over 3 weeks ago.

**With the US 10 year bond yield at 1.82%, the Australian 10 year bond is now trading at just a 50bp premium. In contrast, the Australian cash rate remains at a 150bp premium to the Fed Funds Rate. This provides further confirmation that the RBA will have to cut rates again. Indeed, bank bill futures are pricing an 80% chance of a 25bp rate in August and a 92% chance in September. Given the dramatic revision of inflation forecasts, I wouldn't be surprised to see the cash rate at 1% or even lower." Don't ask: why? ask: why not?**

**This prospect OBVIOUSLY has important implications for investors, especially those who rely on investment income to live.**

**First, it appears that Australia is facing the prospect of a deflationary threat similar to Japan and Europe. Second, investors should prepare for an extended lower return environment. Third, with a rapidly declining interest rate differential, the Australian dollar could break below recent lows of $US 0.69c. Fourth, it re-affirms equities as the asset class of choice. Finally, the search for yield has returned with a vengeance.**

It's worth noting that the Chairman of the Future Fund (FF) stated recently that achieving a real return of 5% is "very" difficult with the current level of interest rates. As a result, the FF is rumoured to be in negotiations to either lower its return target from 5% above the CPI level, or gain approval to invest in more risky asset classes.

Meanwhile, the major Australian banks are yielding around 6%, or over 8% grossed up for franking credits. Let's be conservative. Even lowering payout ratios and assuming an aggressive 1% fall in the dividend yields, the grossed up major bank dividend yield still attracts a 525bp risk premium over the cash rate. I reckon that is a risk worth taking. Especially when dividend yield has contributed nearly 60% to Australian total equity returns over the long term.

What else does this mean? It means stocks I have recently written on in the *Switzer Super Report* such as **Telstra, Sydney Airport, Transurban, Star**

**Group, and Southern Cross Austereo will continue to outperform as their dividends are sought, as will US dollar earners, such as Aristocrat, CSL and Treasury Wines Estates in terms of earnings upgrade translation.**

What could easily happen is the RBA cuts rates in August, after the Fed has lifted them in June or July, the world's equity markets are a touch lower, the AUD is lower, but the ASX200 is cum all the big fully franked annual dividends. That is a combination I am saving some cash for and I tend to believe it's worth waiting for that moment, as it will prove an excellent way of generating total returns well above anything available more broadly.

Patience is a virtue in investing, but we also need to have our magazine loaded and targets identified for when they start moving into the "buy zone". This can all happen quickly and the key is to be prepared and ready and willing to pull the "trigger" when the prices are right.

So don't think I am outright bearish, I'm just waiting for volatility to increase and share prices to pull back a notch. Then I will deploy more cash into the right Australian equities, as their potential return over cash increases via their prospective dividend yields alone.

Dividend yield is going to play an ever-increasing role in total returns from equities.

***Important****: This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

# Compare stock valuations and say Yum!

## by Tony Featherstone

Proponents of international investing argue that Australians should allocate more of their portfolio to overseas stocks to improve diversification and access opportunities. A stronger argument – better relative valuations for some offshore stocks – is less considered.

With several star Australian stocks on nose bleeding Price Earnings (PE) multiples, the opportunity is to take profits before June 30 and reinvest in similar overseas companies that are trading on much lower valuation multiples. And, in some cases, are larger, higher-quality companies with bigger global footprints and more diverse product ranges.

Consider the outstanding Australian fast-food franchisor, Domino's Pizza Enterprises (DMP). Great company, great product, great management. Few CEOs know their product as intimately as Don Meij at Domino's, or have as much capacity to disrupt local and offshore markets.

The market is abundantly aware of Domino's growth trajectory. At $68.48, it trades on a whopping PE multiple of 51 times forecast 2016-17 earnings, using consensus analyst estimates. Domino's is priced for perfection and then some.

**DMP**


*Source: Yahoo!7 Finance*

Now consider the US fast-food gorilla, Yum! Brands Inc. (YUM), operator of Taco Bell, KFC, Pizza Hut and other prominent consumer brands. At US$81.25 share, Yum! trades on a forecast 2016-17 PE of about 20 times, using consensus estimates. McDonald's Corp, too, trades on a forecast PE of about 20 times.

Yum! is about 10 times larger than Domino's by market capitalisation and has more than 43,000 restaurants in over 130 countries and about half a million employees.

Yum! is well placed to capitalise on the coming boom in Asian middle-class consumption and rising demand in Western-style fast food. It has 16,500 restaurants in emerging markets, more than double its nearest competitor. The top 10 emerging markets have 2.5 restaurants per million people; the US has 57 restaurants per million.

**YUM**


*Source: Yahoo!7 Finance*

Domino's exposure to Asia is through its Japanese business, a terrific acquisition that has exceeded expectations and taken the pizza operator to new heights. But Domino's does not offer anywhere near the same leverage to emerging market consumers as Yum!

That does not mean Domino's investors should dump all of their stock and rotate in Yum! on a whim. Nor does it suggest Yum! is a screaming buy; consensus analyst estimates suggest Yum! is slightly undervalued at the current price. But this simple comparison reinforces the need to compare star Australian stocks with their closest overseas peers, in the search for better relative value.

Domino's deserves some valuation premium. But is it worth paying two-and-a-half times more compared to the much larger, more diversified Yum! Brands at the forecast PE multiple? On a relative valuation basis, Yum! looks the superior investment at current prices.

Granted, buying US stocks over Australian ones adds a layer of currency risk and PE multiples can be a crude, flawed way to compare stocks (given the metric relies on market price as an input).

But compare several star Australian stocks to their nearest overseas peers and the valuation gaps are stark. It makes no sense for local investors to pay so much more for companies when their overseas equivalent is bigger, better and cheaper.

That is the price of investing only in an Australian market that, frustratingly, resembles Noah's Ark in too many sectors: a pair of overvalued elephants in their industry and not much else. This market's small size and limited choice in high-growth industries arguably adds to valuations premiums in fast-growth companies.

**Offshore medical device companies appeal**

Investors who want Australian healthcare exposure, for example, have a handful of large companies to choose from.

The same is true of medical devices, once one gets beyond Cochlear (COH) and ResMed Inc (RMD).

Compare Cochlear with US medical devices giant Medtronics Inc. At $118 a share, Cochlear trades on a forecast PE multiple for 2016-17 of 31 times, using consensus analyst estimates.

At US$81.89, Medtronic Plc is on a forward PE of 17 times next financial year's earnings.

**COH**


*Source: Yahoo!7 Finance*

Like Domino's, Cochlear is a great Australian company. But it focuses on one main area: implantable hearing devices. Medtronic (MDT), the world's largest medical devices company, develops a wide range of medical technologies, operates in more than 140 countries and has 86,000 staff.

**MDT**


*Source: Yahoo!7 Finance*

Medtronic's product and geographic exposure, far superior to any Australian medical device company, means it has less risk if something goes wrong. A similar argument can be made comparing ResMed Inc, which focuses on sleep apnoea technology, with Medtronic. Like Cochlear, ResMed trades at a significant valuation premium to Medtronic, which is many times larger.

**Hospital stock valuations look healthier overseas**

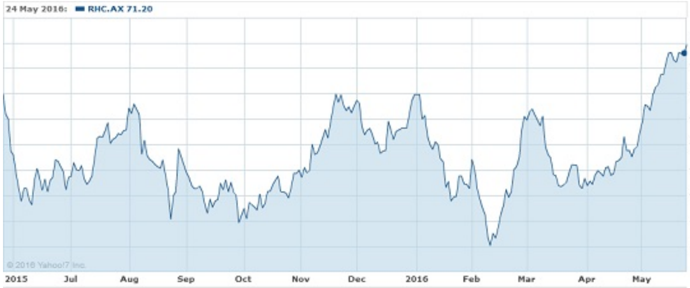
Similar valuation gaps appear between Australian and offshore hospital operators. Ramsay Health Care (RHC), one of this market's best long-term performers, trades on a forecast 2016-17 PE multiple of 27 times, using consensus estimates. HCA

Holdings Inc, the largest private hospital owner in the US, trades on a forward PE of 11 times.

Another US hospital giant, Universal Health Services, trades on a forecast PE of 16 times. Tenet Healthcare Corp., owner of more than 80 US hospitals, can be bought on a forward PE of 12 times. Ramsay has good long-term prospects, but it is hard to argue it warrants a valuation multiple more than twice that of several of the largest US hospital stocks.

Australian investors partly pay more for Ramsay because it is so hard to get hospital investment exposure in this market. US investors, meanwhile, are paying low double-digit valuation multiples for some outstanding hospital companies in one of the great long-term growth industries.

**RHC**




*Source: Yahoo!7 Finance*

Comparisons between Australian healthcare stocks and exchange-traded funds over global healthcare companies also highlight extreme valuation gaps.

An Australian investor who buys CSL, for example, could instead gain exposure to a basket of the world's best healthcare companies through the ASX-quoted iShares Global Healthcare Exchange Traded Fund (ETF).

CSL trades on a forward PE of 34 times. The iShares Global Healthcare ETF  (IXJ) trades on a historic PE of 21 times (forward forecasts are not available).

The ETF provides exposure to 1200 of the world's largest healthcare, biotechnology and medical device companies, and its top holding include giants such as Johnson & Johnson, Novartis, and Pfizer.

**IXJ**


*Source: Yahoo!7 Finance*

Long-term investors, who want to add healthcare exposure to portfolios and are content with index exposure and aware of currency risk, will find superior diversification and value in the iShares ETF compared to the largest Australian healthcare stocks.

**Stronger appetite for overseas consumer staples companies**

Consumer staples is another long-term growth industry as emerging market consumers upgrade their diets in coming years.

One can buy Wal-Mart Stores Inc in the US on a forward PE of 15 times or plump for the underperforming Woolworths (WOW) on 17 times 2016-17 earnings.

Those who prefer conglomerates can pay 18 times for Wesfarmers (WES) or 17 times for General Electric Company, one of the great global conglomerates, based on consensus forecasts.

Entertainment is another example. I am bullish on the prospects for entertainment companies in Asia as consumers there allocate more disposable income to leisure.

Investors can buy Village Roadshow on ASX on a forward PE of 14.5 times or The Walt Disney Company (DIS) on 16 times.

**VRL**


*Source: Yahoo!7 Finance*

No offence to Village (and apologies for comparing to the US giant), but its entertainment footprint is Mickey Mouse compared to Walt Disney.

**DIS**


*Source: Yahoo!7 Finance*

The Walt Disney Company is killing it with its investment in the Star Wars franchise and never-ending superhero movies, yet trades on roughly the same valuation premium as several larger Australian entertainment or leisure stocks. Nothing in Australia's entertainment sector comes close to the long-term potential of Walt Disney in Asia.

I could go on with other valuation discrepancies between star Australian companies and their closest overseas peers. Yes, using PE multiples is only one way to compare stocks and there can be good reasons for a higher PE if the Australian company has superior growth prospects.

This market's concentration in banking and resources stocks, and lack of choice in healthcare, information technology, consumer staples, alternative energy and other growth industries, is adding to valuation premiums and widening the gap between Australian and leading offshore companies in certain sectors.

Before buying star Australian companies on big PE multiples, compare them to their closest offshore peer. Ask if the local versions deserve to trade at a significant premium to larger, more successful offshore companies. Perhaps the Australian company deserves its higher price, but being blind to offshore value is a sure way of paying too much for stocks.

*– Tony Featherstone is a former managing editor of BRW and Shares magazines. This column does not imply any stock recommendations or offer financial advice. Readers should do further research of their own or talk to their adviser before acting on themes in this article. All prices and analysis at May 19, 2016.*

***Important:*** *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

# ASX200 hold and stay, not go away

by Gary Stone

The ASX200 has continued a steady rise over the last month, making May of 2016 a “hold and stay” rather than a “sell and go away”.

The daily chart below of the ASX200 shows the steady advance from around 4910 in mid-April and right through May.

The ASX200 has risen from below to above:

1. the thin black downward slanting trend line, and
2. the middle blue resistance zone.

Technically this is a positive move breaking above some resistance.

The middle blue zone has now become a support zone, above which the ASX200 must remain to indicate further strength.

*Source: Beyond Charts*

The major challenge that now lies ahead is to penetrate the overhead resistance zone, which spans a wide range between 5400 and around 5540.

I say ‘around’ as there are a number of points that can be used to determine the lower and upper boundaries of the zone. But it is a resistance zone nonetheless and a rise above this zone would be a strong indication of continuing strength.

The immediate target is 5550 to confirm the current steady advance, and then on and upwards to 5700 to challenge the upper black channel line.

On the flipside, a fall below 5270 and then remaining below that level for more than seven trading sessions would indicate weakness and a potential fall back to the major support zone of 4930 to 5000, the lower blue support zone.

Clearly, to achieve such an advance will require price advances in both large cap resource stocks and the Australian Financial sector, especially the large banks.

Other sectors are playing their supporting role, such as Health, Insurance, REITs and Industrials.

The four major banks have reached their own resistance zones (not shown) and have to break above these to play their role. Short-term technical indications are that they might suffer a small retracement before doing this.

An immediate break above their resistance zones in the next two to three trading sessions would indicate better price momentum than suffering a retracement first.

The major resources stocks in the ASX20, BHP, RIO and Newcrest are currently retracing after strong advances. This is normal. An expected bounce in these will assist the cause for further upward momentum.

In summary, the ASX200 continues to surprise and looks a lot better than many are giving it credit for.

*Gary Stone is the Founder and Managing Director of Share Wealth Systems.*

***Important**: This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

# Professional's Pick - Sirtex Medical (SRX)

by Sean Fenton

**Sirtex Medical (SRX)**

**How long have you held the stock?**

Since May 2015.

**What do you like about it?**

The company has a unique medical device to treat patients with liver cancer. SIR-spheres are micro resin spheres coated with yttrium-90 to deliver targeted radiation therapy. The spheres are sized to ldge in the vasculature supporting liver tumours and can deliver a more direct treatment with lower side effects.

The treatment is approved in the US as a combination therapy in inoperable secondary liver cancer and, more broadly, as a medical device across Australia, New Zealand, the EU and many countries in Asia.

**How is it better than its competitors?**

It is a more targeted approach than broad radiation and chemotherapy, which helps to reduce side effects and improve efficacy. It has the opportunity to be approved for first line treatment in primary liver cancer, which would significantly increase the size of the addressable market.

Even without this, it should be able to deliver strong earnings growth, as it continues to increase its penetration of the existing market.

**What do you like about its management?**

Sirtex has a solid management team that has been together now for almost 10 years.

The team has successfully restructured the business, repositioned the product and has grown revenue by more than 10 fold.

**What is your target price on SRX?**

$45.00, but that would move higher if the $A continues to fall.

**At what point would you sell it?**

Aside from the development of new cancer treatments, there are a number of clinical studies globally looking at the effectiveness of SIR-Spheres in treating liver cancer.

Should these trial results not support expansion of the product as a first line treatment we would reconsider our position.

**How much has it added (subtracted) to your overall portfolio over the last 12 months?**

It has added a modest amount to portfolio performance in excess of the market.

**Is it a liquid stock?**

Yes, it is in the top 100 largest stocks listed on the ASX and turnover recently has been in excess of $11 million per day.

**Where do you see the value?**

The use of SIR-Spheres for the salvage liver cancer market is still very under penetrated and more so outside of the US. In Asia for example, where there is a high level of primary liver cancer, SIR-Sphere's penetration is less than 1%.

We should continue to see double-digit volume growth from the business in the foreseeable future, which could accelerate with the approval for use in more indications.

**Sirtex Medical (SRX)**


*Source:Yahoo!7 Finance*

**Sean Fenton is Portfolio manager with Tribeca Investment Partners. Tribeca funds are distributed by Grant Samuel Funds Management.*

*Important: This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

# Buy, Sell, Hold – what the brokers say

by Staff Reporter

**In the good books**

**Aconex (ACX) Upgraded to Buy from Neutral by UBS B/H/S: 5/1/0**

Share price weakness is creating a buying opportunity, UBS maintains. The stock has declined 17% since the start of May, despite strong quarterly cash flow and relatively stable prices among international peers.

UBS believes the business is high quality and post the acquisition of Conject, it is the dominant player in the industry with over 40% market share.

**AP Eagers (APE) Upgraded to Add from Hold Morgans B/H/S: 1/2/0**

The trading update suggests to Morgans that the strong momentum continues. The broker forecasts 15.7% earnings growth in FY16, which will mark the third consecutive year of strong growth for the company.

The broker expects upside form the used car strategy should start to emerge meaningfully in FY17.

The broker believes large dealership operators are well placed to adjust to any potential changes in the finance and insurance area of their business, given the ongoing ASIC investigation. Still, there is a risk, given this area is a significant earnings contributor.

**CYBG (CYB) Upgraded to Add from Hold by Morgans B/H/S: 4/1/0**

First half profit beat Morgans forecasts, with lower-than-expected costs cited as the reason. Cost guidance has been revised down and the bank does not expect costs to increase over the medium term.

Morgans increases earnings forecasts by 9.0% for FY16 and 13% for FY17 and upgrades its rating to Add from Hold. The broker notes commentary around the potential IRB accreditation for regulatory capital was also positive.

**Flight Centre (FLT) Upgraded to Outperform from Neutral by Credit Suisse B/H/S: 2/4/1**

Credit Suisse upgrades to Outperform from Neutral following the sharp share price reaction to the profit downgrade. The broker acknowledges the call is not without risks as the company is pursuing an aggressive expansion in non-traditional business.

Although the company missed super over-ride hurdles, because of airfare deflation, the broker believes the Australian market is long on capacity and therefore these hurdles are likely to be addressed in FY17.

The broker believes the competitive position of the company depends on its success at developing a strong multi-channel offering as the historical shop front business declines.

**LifeHealthcare (LHC) Upgraded to Buy from Neutral by UBS B/H/S: 1/0/0**

Assuming a slower trend in surgical procedures persists, UBS factors in the potential downside risk by reducing FY16 earnings estimates by 22.5% and FY17 by 25.7%.

The broker expects the company can reliably generate 4.0% revenue growth and could accelerate this growth with positive reforms in anti-competitive prosthesis pricing as well as potential M&A.

The possible changes have been deferred and are unlikely in 2016 but the broker expects, regardless of the outcome of the federal election, the reforms will proceed.

**Programmed Maintenance Services (PRG) Upgraded to Buy from Hold by Deutsche Bank B/H/S: 3/1/0**

The FY16 result goes a long way to easing Deutsche Bank's concerns. Lower net debt and the cash flow outlook provide more comfort in the investment proposition.

FY17 earnings guidance has been reiterated at $100-110m, which appears optimistic to the broker, given continuing pressure in mining, but that level of earnings is not considered necessary to justify the valuation. The company has noted that customers in retailing, tourism, transport and manufacturing are hiring and spending on assets.

**Resolute Mining (RSG) Upgraded to Equal-weight from Underweight by Morgan Stanley B/H/S: 0/2/0**

The stock has rallied sharply, with Morgan Stanley observing it up 235% over four months. The broker adds value for the three projects with feasibility studies due this quarter but notes the market reaction could be mixed, depending on what was assumed.

This entails an upgrade to Equal-weight from Underweight, although the broker maintains it is not prepared to chase the equity but looks for a pull back to create upside.

In-Line Industry view is retained.

**Wesfarmers (WES) Upgraded to Hold from Lighten by Ord Minnett B/H/S: 1/6/1**

The company has announced impairment and restructuring charges for Target and Curragh coal mine. The amounts were larger than Ord Minnett expected but not a complete surprise, given the poor performance of the two.

Earnings revisions are significant, the broker observes, with normalised profit forecasts down 8.0% in FY16. Target is expected to incur a loss of $50m.

The broker upgrades its rating to Hold from Lighten, given the challenges facing the two businesses are now factored into the results while concerns around lower earnings growth at Coles are now better appreciated.

**Westpac (WBC) Upgraded to Outperform from Neutral by Macquarie B/H/S: 6/2/0**

Macquarie's economists are increasingly bearish on the macroeconomic outlook and as such expect the RBA to cut to 1.00%. Such stimulus should nevertheless support local economic growth. In a tougher environment the broker believes Westpac offers a better defensive proposition than peers.

Westpac is underweight WA and the resource sectors, has upside potential from mortgage repricing as interest rates fall and the dividend yield to support the stock in a low rate environment.

**In the not-so-good books**

**APA Group (APA) Downgraded to Neutral from Buy by Citi B/H/S: 3/5/0**

Citi has come to the view the risk for bond yields/interest rates has shifted to the upside and this should impact on bond proxies in the share market.

APA is being singled out as the most growth constrained, offering lower yield than its peers and, with only 15% of its operations regulated, more sensitive to rising interest rates.

**Beach Energy (BPT) Downgraded to Sell from Neutral by Citi B/H/S: 1/3/2**

Citi analysts have turned more positive on crude oil prices, now predicting a recovery to US$52/bbl by 4QCY16. As things are turning for the better, the crude oil market is anticipated to reach equilibrium by mid-year and deficits for multiple quarters thereafter.

Citi analysts see upside for oil & gas producers in Australia, but weaker oil prices remain a key risk. Beach Energy is not seen as representing value at the current share price which is seen as too high. Downgrade to Sell from Neutral.

**BlueScope Steel (BSL) Downgraded to Hold from Accumulate by Ord Minnett B/H/S: 4/3/0**

Ord Minnett observes, while the company has upgraded earnings guidance for the second half, steel spreads have peaked and further positive catalysts are hard to find.

Guidance has been upgraded on the back of better domestic volumes and earlier-than-expected realisation of cost savings.

Hence, while acknowledging the company has positive momentum and a history of beating guidance, the broker reduces its rating to Hold from Accumulate.

**BlueScope Steel (BSL) Downgraded to Neutral from Buy by UBS B/H/S: 4/3/0**

BlueScope has upgraded earnings estimates for the second half, driven largely by pulling forward cost cutting initiatives and better volumes in the domestic business. UBS retains estimates for FY17-18, as the company continues to be highly leveraged to changes in steel spreads.

The broker believes the bias to spreads is to the downside in the absence of a sustained turnaround in demand. With most of the positives now priced in the rating is downgraded to Neutral from Buy.

**Commonwealth Bank (CBA) Downgraded to Underperform from Neutral by Macquarie B/H/S: 3/4/1**

Macquarie's economists are increasingly bearish on the macroeconomic outlook and as such expect the RBA to cut to 1.00%. Such stimulus should nevertheless support local economic growth. In a tougher environment the broker believes CBA will face headwinds.

CBA is overweight WA and the resources sectors and will suffer lower margins on its bigger deposit book. Solid capital generation will support dividends but on CBA's premium valuation to peers, the yield is lower, the broker notes. On such a premium, and with limited catalysts for further outperformance, Macquarie downgrades to Underperform.

**Evolution Mining (EVN) Downgraded to Neutral from Outperform by Macquarie B/H/S: 3/3/0**

Macquarie analysts observe the ongoing rally in Australian gold stocks. They have decided to downgrade two stocks under coverage on the basis of their share price offering reduced potential for further upside.

**Flight Centre (FLT) Downgraded to Hold from Buy by Deutsche Bank B/H/S: 2/4/1**

The company has downgraded FY16 profit guidance to a decrease of 2-5.0%. Deutsche Bank notes turnover continues to grow and this suggests underlying sentiment is not that bad.

What does concern the broker is that airline competition and capacity increases mean the company's total transaction value is split among more carriers. This is not delivering sufficient growth required to earn the super over-riders, which have underpinned margins in the past.

**JB Hi-Fi (JBH) Downgraded to Sell from Neutral by Citi B/H/S: 2/5/1**

Citi analysts are of the view the appliances tailwind for retailers is fading as competitive and cyclical headwinds are emerging for retailers. JB Hi-Fi is downgraded to Sell from Neutral.

To back up their view: the analysts point out Harvey Norman (HVN) already is Sell rated. Citi analysts don't think the metrics stack up for a successful and advantageous offer regarding The Good Guys for JB Hi-Fi.

**Oil Search (OSH) Downgraded to Sell from Neutral by Citi B/H/S: 3/1/2**

Citi thinks Oil Search is paying dearly for InterOil. The deal is made accretive through Oil Search raising fresh capital at an elevated share price, in the analysts view.

**Regis Resources (RRL) Downgraded to Neutral from Buy by Citi B/H/S: 1/2/4**

A general update on commodities prices has led to a

5% lift in the forecast average gold price for 2016: to US$1,255/oz but weaker bullion is anticipated for 2017.

Regis Resources has been downgraded to Neutral from Buy on valuation.

**Regis Resources (RRL) Downgraded to Underperform from Neutral by Macquarie B/H/S: 1/2/4**

Macquarie analysts observe the ongoing rally in Australian gold stocks. They have decided to downgrade two stocks under coverage on the basis of their share price offering reduced potential for further upside.

**South32 (S32) Downgraded to Neutral from Outperform by Credit Suisse B/H/S: 2/5/1**

The stock has outperformed peers in the last six months by some margin and Credit Suisse believes earnings risk is to the downside given the spot commodity outlook and FX, while earnings risk is to the upside for large cap peers given their iron ore exposure.

Hence, while the broker does not have a negative view on the stock, the rating is downgraded to Neutral from Outperform.

**Suncorp (SUN) Downgraded to Neutral from Outperform by Credit Suisse B/H/S: 3/4/1**

Credit Suisse finds the valuation is getting tough. The broker supports the company's new operating model but notes the stock has outperformed this year and near-term headwinds have increased.

The company has suggested that revenue growth is limited and improvement in the underlying insurance margin is likely to be small. Credit Suisse also suspects a special dividend is unlikely in FY16.

**Suncorp (SUN) Downgraded to Neutral from Buy by UBS**

The company has promised to deliver on strategy rather than unrealistic growth targets, UBS notes, yet suspects the message on medium term growth is softer.

UBS still believes delivery on margin in general insurance is the main issue and the company is on track. Following the outperformance since February the stock is now closer to fair value and the rating is downgraded to Neutral from Buy.

Rationalisation of the five separate businesses into a more unified structure is expected to deliver $80m in pre-tax savings by FY17.

***Important**: This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

# Questions of the Week – Mid-cap ETFs and hedged or unhedged global infrastructure funds

by Questions of the Week

**Question: Can you please advise an appropriate ETF to invest in mid-cap stocks?**

**Answer (by Paul Rickard):** I am not aware of any ETF that specifically covers mid-cap stocks.

I think that if you look at iShares IOZ (which covers the ASX 200) or Vanguard's VAS (which covers the ASX 300), you can pick this area of the market up.

Some of the listed investment companies, such as Geoff Wilson's WAM, tend to hone in on this area – but I would be very wary about paying a premium to invest in some of the better performing LICs.

**Question: I'm looking at investing in some global infrastructure funds but I am uncertain about whether to go with hedged or unhedged funds at this time. Could you explain the impact of both, with changes in the AUD versus the USD in particular, please?**

**Answer (by Paul Rickard):** It really comes down to your medium term view on the AUD.

If you think it is going to weaken (i.e., head below 70 US cents down towards 60 US cents), go unhedged.

If you think the AUD may strengthen, or for that matter, hang around this level for some time, go hedged.

My take – while I think the AUD may yet test 70c, this sort of level of around 70 to 75 cents looks to me close to fair value – so I would be inclined to be hedged.

You probably have more fund choice with unhedged funds – and sometime, the Manager will also manage the currency risk.

*__Important:__ This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*