25 June 2009 | Issue 24

MORNINGSTAR™

Huntleys' Your Money Weekly

Forecast 2009–10

After the Great Banking Panic, we're positive for Australia!!!

Conclusions: **(1)** The market bottomed early March **(2)** after shocks could last for a while yet **(3)** V or a W recovery: open question. **(4)** resource supercycle intact.

Quote: "When as a young and unknown man I started to be successful I was referred to as a gambler. My operations increased in scope and volume. Then I was known as a speculator. The sphere of my operations continued to expand and presently I was known as a banker. Actually I had been doing the same thing all the time."

Bernard Baruch, the Warren Buffett of the first half of the 20th century quoted this in outlining his investment philosophy in *My Own Story*, his 1957 autobiography written at age 87. After examining the chart of the US banking index from 2007/2009, this quote should become part of all bankers' learning curriculum! Baruch added: "The elder J.P. Morgan could gag at the word 'gamble' when I used it. Still, the truth is there is no investment which doesn't involve some risk, and is not something of a gamble."

Quote Baruch: "Whatever men attempt, they seem driven to try to overdo. When hopes are soaring, I always repeat to myself, 'Two and Two still make four and no one has ever invented a way of getting something for nothing.' When the outlook is steeped in pessimism I remind myself, 'Two and two still make four and you can't keep mankind down for long.'"

Buffett in late February described the current crisis as a Great Banking Panic, and the accompanying chart of the US Banking index shows why. The Index peaked in February 16, 2007, and collapsed 85% to bottom on March 6, 2009, taking the S&P 500 index which peaked October 31 down 57% to 666.79 on March 6.

The 2007/2009 banking panic warrants additional chapters in Charles Mackay's 1841 text: *Extraordinary Popular Delusions and the Madness of Crowds*, a favoured Baruch text in examining historical panics and crashes. For along with The Tech crash of 2000–2003, the size of this banking crash rivals the 1929/32 affair. The charts are almost identical.

A chart of the US housing index, the precursor of this Panic, peaked in July 2005, and fell 80% into March 6, falling from a secondary peak around 250 on February 2, 2007. Housing's role has been widely discussed as one example of the poor lending practices which led to this collapse.

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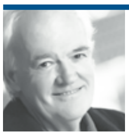
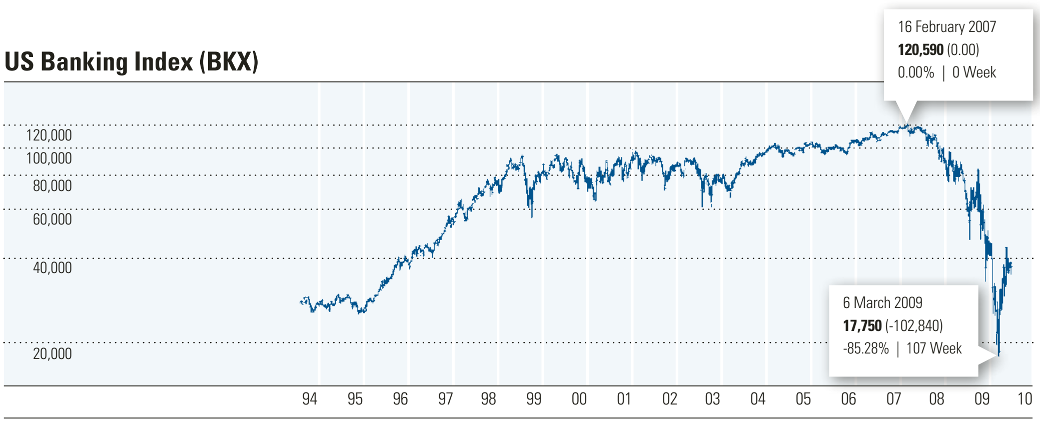


Ian Huntley
Editor

US Banking Index (BKX)



Source: Dynamic Trader v.4 © 1996–2003

Continued on page 2

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Overview continued from Page 1

Key Terms

Buy: Suitable for purchase now.
Accumulate: Undervalued, but there is time to purchase.
Hold: Appropriately priced, neither buy nor sell.
Reduce: Sell part holding.
Sell: Sell all holdings now.
Avoid: Not investment grade.

Moat Rating: The moat is the competitive advantage that one company has over other companies in the same industry. Wide moat firms have unique skills or assets, allowing them to stay ahead of the competition and earn above-average profits for many years. Returns on their invested capital will exceed the cost of that capital.

Business Risk and Share price risk: The analyst's opinion of a company's business and share price risk relative to other stocks. Cyclical and speculative companies will be riskier on both counts. Low-risk businesses can be overpriced and high risk businesses can be cheap.

Morningstar Equity Style Box: is a nine-square grid that provides a graphical representation of the "investment style" of stocks. It classifies securities according to market capitalization (the vertical axis) and growth and value factors (the horizontal axis).

Investment Style

Value	Blend	Growth	**Mkt Cap**
			Large
			Medium
			Small

Ratios and Data

NPAT: Net Profit After Tax – before one offs.
EBIT: Earnings before interest and tax.
ROE: Return on Equity (net profit before one-offs / shareholders equity)
Net Interest Cover: EBIT / net interest expense
Annual Share Turnover %: number of shares traded as a percentage of total shares outstanding over the last 12 months.
Div Yield %: Historic numbers: dividends paid for that year divided by the average monthly closing share price for that year. Forecasts: dividends paid divided by last close share price.
P/E: Historic numbers: average monthly closing share price for that year by earnings per share. Forecasts: last close share price divided by earnings per share.

In Australia the Property Trust Index closely followed the US Banking Index as the chart shows in our section on AREITS. It peaked on February 9, 2007, bottomed March 13, 2009 – down 79%. That's an horrific crash, for in Property Trusts so many retirees trusted. The problem – they borrowed relatively short term money from syndicates of global banks who used to come knocking on their doors. "Beware Banks bearing Gifts." Ancient Greek saying! To ensure "security" in their loans, they came gift wrapped with complex derivatives, a proper nest of vipers.

This Panic occurred in what Pimco's Bill Gross trademarked as The Shadow Banking system, which accounted for some 30 to 50% of the US, perhaps global, banking credit. Chief players were the 40 times leveraged global investment banks of Europe and the USA. Like all great bubbles it swamped most regulators and spilled to all corners of the world, from our local councils to Iceland. As we now know the investment banks and many banks stuffed themselves with their own cooking. As our review of Australian banks inside notes, we avoided this cooking, our banks remain in relatively great shape, a great boon to our economy as the flow of credit did not grind to a total halt, then into reverse as in the US.

After every panic, there is an inquiry and a new regulatory system is put in place. But people, being people, proceed regardless and as Baruch noted: "Another strange thing about these crowd madnesses is that education and high rank is no immunization against the virus. Mackay's book is full of examples of how kings and princes, merchants and professors, have succumbed to these crazes…"

Why this is no 1929/1932: how it is panning out

Milton Friedman and Anna Schwartz in *A Monetary History of the United States* (1963) argued that allowing a 33% collapse in the stock of money in the US between 1929 and 33 – primarily between 1930 and early 33 – was the major causal feature of the Great Depression. Velocity of circulation fell 29%, and net national product, 53%. Then the US Fed Reserve mistook falling interest rates for easing financial conditions, ignoring the collapse in money supply. Bank failures triggered further bank failures and what may have been good loans, turned sour in a vicious

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Declaration

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circle as forced sale followed forced sale, slamming all asset values.

When the disasters of the second half of 2008 unfolded – in extraordinary rapid fire – the Central Banks eased massively. Money supply in the US burgeoned, though in recent months the Fed slowed down to crimp annualised rates of monetary growth. Many governments rescued ailing banks with massive capital injections where necessary. Their actions aimed at procuring an orderly realisation of troubled asset portfolios. Direct injections of cash into household coffers aimed to prime spending.

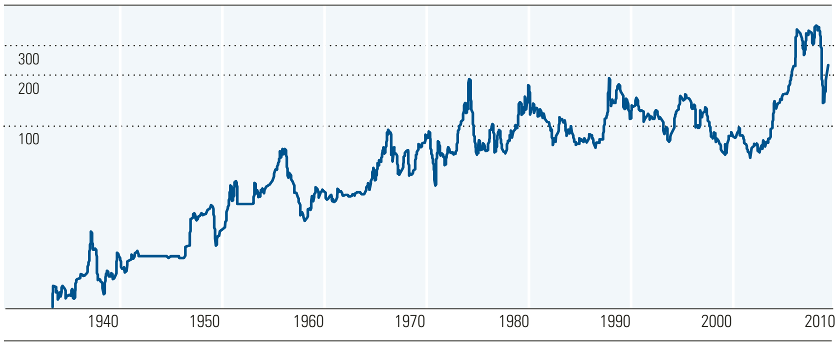
Warren Buffett currently believes the US economy remains in recession/depression – "a shambles" – and needs yet another stimulus package.

Over the last year, US money supply as measured by M2 is up 9%, a far cry indeed from the terrible 1930/33 experience. It does its work in wondrous ways – (1) through bringing down interest rates (2) increasing available liquidity and (3) enabling the astonishing round of equity issues that is recapitalising corporates and banks alike globally.

All Ords Index

Source: TradeStation 2000i by Omega Research© 1999

High Grade Copper



Source: TradeStation 2000i by Omega Research© 1999

Anna Schwartz at age 95/96 and others warn that though it might take several years, such a monetary injection would end in inflation. But will it? There is the Japanese experience – definitely no inflation, and some argue that is where the US is headed. The other argument is that after several years of low inflation it will emerge. But severe inflation assumes no counter action by the central banks, unlikely. Higher interest rates then – yes. The bigger long term problem is growing US fiscal deficits as far as the eye can see.

In Australia we depend on variable interest rates to finance housing. The Reserve Bank's initial 400 basis point slashing of interest rates rapidly translated to a boost to the consumer pocket. In the US, far more dependent on fixed mortgages, it took far longer to get those rates down.

Since second quarter last year equity capital raisings between banks and corporates in Australia total \$70–\$80 billion heading for \$100bn by end 2009. These equity raisings are amazing – previous bear markets I have experienced since the early 60s – let alone 1929/32 – saw a near total incapacity to raise equity. Australia, one of the least affected countries by the Panic, was also first out of the blocks and charged massively ahead with these equity raisings which largely slash debt as banks order: "Get your balance sheet right. I'm not going to lend you money until you do!"

The rest of the world in recent months is catching up. The capital raisings "deleverage" many corporates, a very healthy procedure for the economy as it means there is that much less pressure on them to sack employees. A lot less corporate failures, too!

Central bank actions enabled many measures of the Panic to unwind. In many countries, but not Australia, Governments directly injected funds to recapitalise banks. As yet, there are little signs of recovery in the Shadow Banking system, or securitised packaged debt, whether they represent residential mortgage or corporate debt. The easing is best shown in the collapse of the London Interbank Borrowing rate, a measure of the overnight rate charged by banks to each other – credit froze last year. Banks didn't trust each other or their customers. Recapitalisation of the banks offshore by their governments, and government guaranteed deposits greatly eased this Panic. But credit is still tight and more loosening must emerge.

Friedman and Schwartz argued that alleviation of the monetary contraction in 29/33 would not have stopped a recession, but would have stopped it degenerating into the worst downturn in US and global history. This feat has been accomplished today, I believe.

Australia vs The USA: Lucky Country!

Australia comes through this panic remarkably well. Our housing markets have not suffered to the same extent as in the US as we had very little exposure to sub prime loans. Our banks remain profitable and continue to lend, they did not require government rescue, and the big four are now in the world's eight top rated banks! A triple A Government deposit guarantee helped due to their reliance on offshore wholesale funding, when the rest of the world brought in guarantees.

The elephant in the US room is household debt, also in Australia but to a lesser extent as explored in our Retail section. In our 26 March issue we explored the contrast between US and Australian household debt. The US Household faces rapidly rising unemployment, plus around 35% falls in the value of their homes and great difficulty in selling them. The Australian and US households have similar interest cost to income ratios – but the US Household is bedeviled by wretched asset quality. The US household has to save more and more and the savings ratio is rapidly ratcheting up at the expense of consumption.

These much quoted savings ratios are after money spent on investment – it's the cash that's saved. So the American household is curtailing investment and focusing disposable income on necessities. It will take several years at least for the US consumer to work through their balance sheet issues and there could well be a major generational change in attitudes to debt as there was after the Great Depression. Even with a worst case 15% unemployment as against more like 11% middle road forecasts, the 85% employed are still a powerful force.

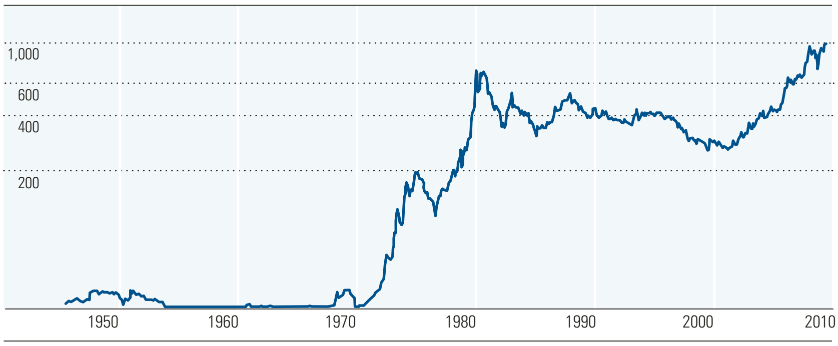
Australians have higher asset quality on their balance sheets, and our economy is doing better than most offshore so unemployment is likely to rise far less than in the US. The pessimistic case for Australia is 9% against more optimistic current views around 7.5%. Australian households are helped by the rapid collapse in the cost of money, the big fall in the price of petrol aided by the recent rise in the Aussie dollar, the continuing strength of our export sector, and a sharp upswing in the residential sector thanks to lower interest rates and the First Home Owners Boost. A very different picture to the US, but still a nasty recession.

The global banking sector's ability to provide credit remains handicapped. Many OECD households are sharply reining in spending. To boost the economies Governments are increasing their debt to force investment expenditures, boost employment and get things moving. The private sector's withdrawal from the debt window leaves scope for government action until it gets going again too.

This could result in a stronger business cycle ahead than many currently expect even after a slow start, especially given the size of the Government stimulation around the world particularly in China and India. The impact on resource prices is particularly positive for Australia, as discussed below and in our mining and energy review inside.

Dividends: History tells us that after a severe downturn in the first year dividends are cut approximately 25% – the current experience, in the second year about 12% and in the third year flat – ahead of seven years of rising dividends!

Gold – US$



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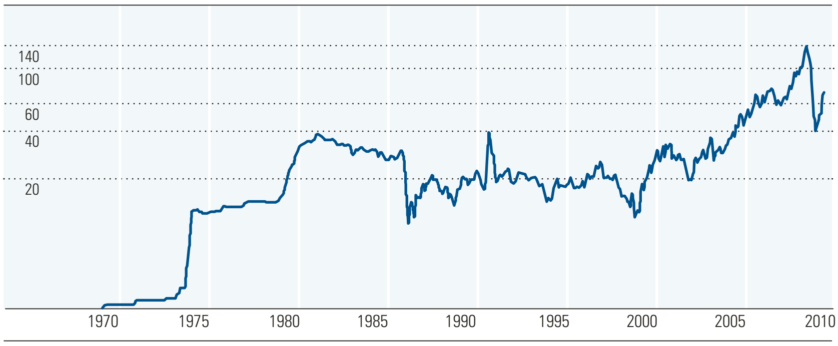
Oil – WTC



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The BRICs (Brazil, Russia, India and China). Until mid last year the BRIC economies supercharged global growth, their own growth running over double the rest of the world, the importance being their overlay on demand from the larger OECD economies. China, India and to a lesser extent Brazil now are traveling well. China and India account for 38% of the global population. Last year was the first that overall energy demand from the developing world exceeded that of the developed world, according to the authoritative annual BP survey. Energy usage is an interesting measure of the size and importance of an economy! Obviously developed world demand is critical too, and it has dropped off sharply reflecting the rapid withdrawal of the credit that drives so much activity. Developing world demand for energy has been stable to growing through this crisis.

My eyes go very glazy over the various ways some economists calculate the size of these economies. I prefer to watch just how much iron ore China imports as an index of its growth, and how it impacts Australia. Our proximity to East Asia make China and Japan – our equal major trading partners – and to a lesser extent, Korea, our most important partners for our vital resource exports.

Courtesy the BHP Billiton results presentation of 4 February these are the approximate Chinese shares of global consumption for: iron ore (58%) energy coal (40%) steel (38%) zinc (35% alumina (35%) aluminium (35%) copper (33%) nickel (33%) and oil (9%). Some 17 to 20% of BHP revenues stem from China. In this presentation, BHP stressed the importance of underlying OECD demand – in essence the developing world broadly provides the sizzle. Ahead this may well develop into the steak, itself, as they continue to grow.

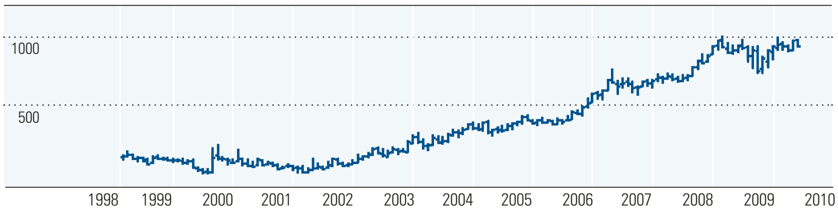
Iron ore and energy coal – two major Australian exports – really stand out. The rest of the world's demand clearly impacts pricing, but our proximity to East Asia means that its demand has an enormous impact on our own export volumes. Chinese imports of iron ore actually increased through this downturn as lower iron ore prices forced many of their higher cost domestic iron ore mines to close. NO tariff protection here!

Incremental demand for energy in 2008 was led by China and India. Both these economies are expected to show high single digit growth next year.

US 30 Year Govt Bond Yield

Source: Independent and Board of Governors of the Federal Reserve System

Gold – Monthly



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The Super Cycle – how does Kondratieff stack up now? Amazing times!!!!

As our charts show, 10 and 30 year bond markets just made major new lows in yield indicating that the long or Kondratieff cycle may have only just bottomed. The Kondratieff argument is that a long cycle in the economies shows in the prices of money, labour, and commodities as demand ebbs and flows. Kondratieff identified a 48 to 60 year cycle which last peaked in 1980. I thought it bottomed between 1998 and 2003 which saw extraordinary lows in metals, energy and interest rates and fell into the time frame. I also felt that China had developed sufficient critical mass to help drive the upwave as a major new entrant to the global economy. The previous cycle topped in 1920, bottomed around 1945/6 with a similar low in bond rates.

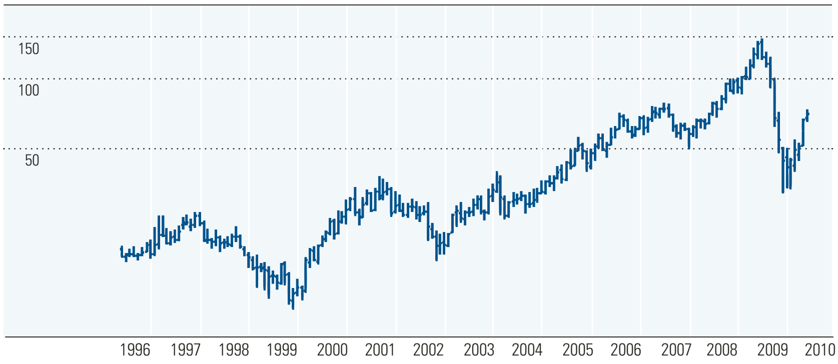
The downturn in the cycle sees a long decline in interest rates, the price of labour, and the price of many commodities. The upwave sees increases and the entrance of major new players in terms of geography – this time China, India, Brazil, previous post wave Japan and the Asian tigers. The earlier upwave began around 1898 –

again the low in bond rates – and saw the USA as the major new entrant driving the upturn.

The emerging giants especially China and India drive this commodities cycle, now termed a "supercycle", of great benefit to Australia. I said there would be "hiccups." I noted that when Japan and US stoked the upwave, they were less than 5% of global population. China and India represent 38%. I pointed to 1974 – the second worst downturn of the 20th century – as one such "hiccup". Then in an upwave, Japan cried force majeure on energy coal and iron ore to cut contracted tonnages by 20%.

Today we have many countries including Europe, the US and Japan, suffering possibly the very worst downturn since World War II, certainly equaling 1974. Yet copper remains above US$2.00/lb after hitting US$1.30/lb, a far cry from US60c/lb in the very late 90s/ early 2000s. Similarly oil is well above the US$15 a barrel levels back then, having hit a low of around $US35 early this year. Iron ore pricing is only back to 2006 levels, which we then thought amazing.

Oil – Monthly



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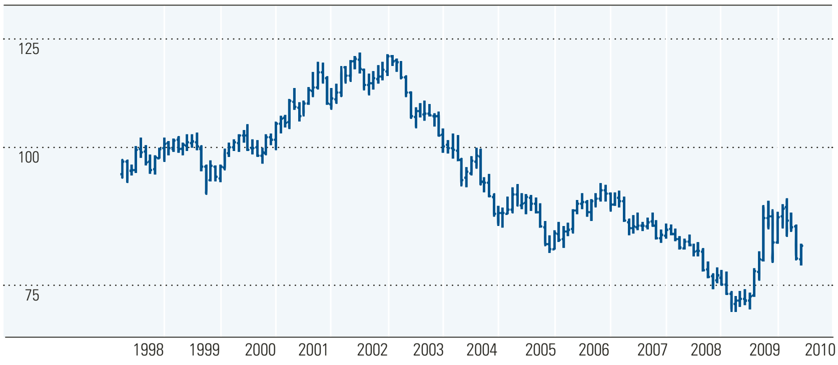
US$ – Monthly



Source: TradeStation 2000i by Omega Research© 1999

Our currency, pretty much a commodity currency, is back to US80c making those who forecast 50c late last year look very wrong.

I do not bother with the hotly debated "decoupling" argument. To my mind the Chinese economy crudely rests on a third a third a third consumption, investment and exports. The Chinese leadership focuses on their history of revolutions so wish to maintain growth and employment at all costs. I've believed they would boost their economy through accelerating infrastructure investment which has a tremendous impact on demand for Australian resources.

My broad view is and was that this would help our major export volumes as we are so close to East Asia, but prices would be weaker due to the OECD downturn.

My reading is that Japan, far harder hit than China, is also now on the recovery trail into 2010. It does have China as a major trading partner on its doorstep!

I remain a fan of the Supercycle continuing and that the Panic has simply been a major hiccup ending the first business cycle of the Upwave, curious though that interest rates do not conform. The debt crisis means credit to fund new projects is much less available further slowing the supply side.

As the business cycle develops through the Teens decade I expect resources to perform strongly. The copper price could easily make new peaks. The strength of resource prices through this downturn is extraordinary!

Energy and oil

In his introduction to the authoritative annual BP review of energy supply and demand, CEO Tony Hayward said: "Our data confirms that the world has enough proved reserves of oil, natural gas and coal to meet the world's needs for decades to come. The challenges the world faces in growing supplies to meet future demand are not below ground, they are above ground. They are human, not geological."

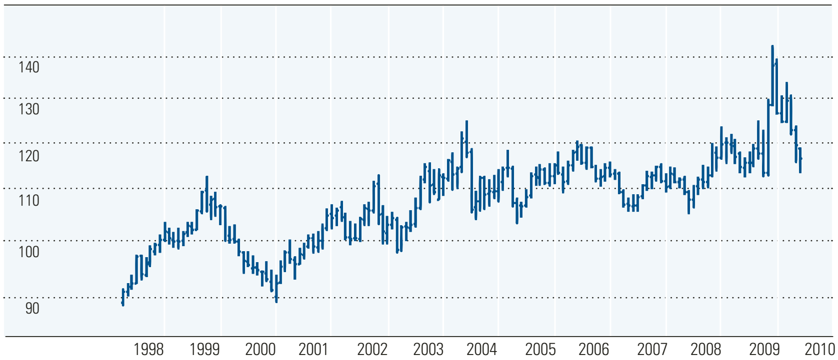
I have been a fan of the Hubberts' Peak argument that the supply of oil is now being overtaken by demand and that the supply of oil itself may well be in the process of peaking. This means higher prices and this encourages alternative sources of energy, the most obvious of which are coal, uranium and

LNG. Wind and solar – especially solar – are emerging as vital new frontiers. Hubbert's Peak does not mean the end of oil but that it is increasingly produced from higher and higher cost sources. The Canadian tar sands is one example. New technology and economies of scale can cut costs but it's hard to replicate cost levels of Arabian deserts.

Again from BP's Hayward: "Primary energy consumption growth slowed in 2008, as did growth for each of the fossil fuels. All the net growth in energy consumption came from the rapidly industrialising non-OECD economies, with China alone accounting for nearly three-quarters of global growth. For the first time, non-OECD energy consumption surpassed OECD consumption. For a sixth consecutive year, coal was the fastest-growing fuel – with obvious implications for global CO2 emissions."

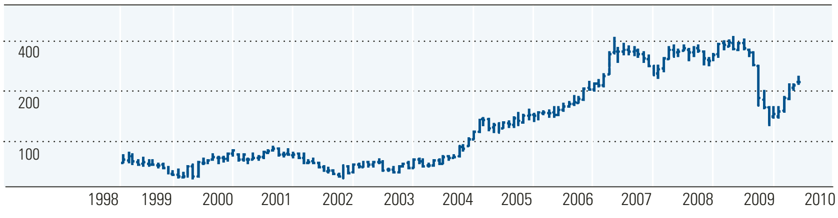
The world will return to growth and Chindia will continue to drive that growth, so it is difficult to see energy prices falling until major new sources develop the technologies and volumes to drive down their cost. We will not see that for a decade or so! But we will see it emerging.

US 10 Year Bond – Monthly (price)



Source: TradeStation 2000i by Omega Research© 1999

Copper – Monthly



Source: TradeStation 2000i by Omega Research© 1999

Global Warming

My view is strongly sceptical. On the Huntley section of our website Mark Taylor, our senior resource analyst who has a strong interest in geology and the long history of Planet Earth, delves through the issues. Like Professor Ian Pilmer whose book Heaven and Earth I recommend strongly – he sees extraordinary change in the global climate via natural causes over millennia.

He points out that sea levels rose around 130m coming out of the ice age 20,000 years ago and in the last 10,000 years have regularly risen and fallen to a lesser degree. Coral reefs have apparently managed to keep pace. It fascinates me that the Antarctic Ice Shelf is growing, not contracting as the Climate lobby claimed. It's a shame that Global Warming activists have so exaggerated – for instance the behaviour of the Antarctic, the prospective rise in sea levels and so on, with little appreciation of the history of even the last 20,000 years when our Native Australians passed through an ice age and dramatic changes in the sea levels. It's tragic that the initial UN report smoothed the variation of just the last 1500 years when warming occurred late in the first 1000 years. Then Greenland was Green and a farming region for the Vikings. They left their farming in the face of cooling that climaxed in a mini ice age in the 1300s. If you are a believer in cycles, Mark's piece suggests a return to another ice age is the more likely path ahead.

As a believer in the environment, I would love to see efforts focus on reducing all pollution. My suspicion is that the Cap and Trade system that we and the US are considering will be too complex, subject to gaming, too costly and will do little to impact carbon emissions. Bureaucrats do love complexity, others game it! Nothing will work unless the developing word takes part and they have many other serious issues.

The Global Warming drive goes cap in hand with the Hubberts' Peak issue in energy: it helps drive the search for alternate sources of energy which is a good thing. None of those yet have the legs to put dents in the need for coal and LNG – two major pillars of our export economy! YM

Sector Reports – Still holding a defensive bias

Peter Warnes
Head of Equity
Research

Australia is in a much better economic state than many western counterparts. It avoided a technical recession with March quarter GDP growth of 0.4% driven by exports with some help from government stimulus packages. But it is possible both the June and September quarters could record negative, albeit small, growth as the terms of trade turn down – a trade deficit was recorded in April – and the full brunt of a recession in the non-farm sector surfaces. This is critical as this is where the jobs are being lost.

The stimulus packages buoyed the consumer in the short term and more permanent tax cuts from 1 July will assist but if unemployment rises to the levels predicted in the budget papers there will be further pressure on total consumption. Sectors likely to show weakness and further job losses include retail, manufacturing, transport –mainly airlines, accommodation and restaurants, property and business services.

Unemployment is a lag indicator. The share market looks forward. The March – mid June rally was led by resources and cyclicals and helped by the recovery in the index-heavy banking sector. This may have been a false start and we are not convinced it is time to switch from a more defensive stance to a growth strategy. There are many hurdles yet to overcome as western economies struggle recessionary forces and governments fund massive stimulus packages. The behaviour of long bond yields will be an influencing factor on the direction of equity markets. As the FY09 reporting season unfolds analysts will increasingly look to the potential magnitude of earnings recovery in FY11. FY10 is expected to be a year where earnings will continue to be under pressure with weakness evident and operating margins still restrained.

In the short term there is still uncertainty. In three to five years time 2009 purchases of banks, energy and diversified mining stocks should look cheap. Defensive growth stocks can be a source of comfort. They may not outperform the market in the upswing but provide some protection in falling markets although then cash is probably the best alternative. Defensive growth stocks can help sleep patterns without medication. Stocks that can be categorised as defensive growth stocks include Woolworths, The Reject Shop and Ramsay Healthcare.

As always, there will be leaders and laggards across sectors. The extent of the disruption to the normal investment cycle makes forecasting more difficult. The record level of new equity raisings has repaired balance sheets and reduced gearing but it has come at a cost – dilution of future earnings per share. This new capital has to be first absorbed and then put to work effectively and efficiently in an economically constrained environment.

Banks recovered strongly from late January lows. All four majors raised new equity and cut FY09 dividends. Will there be further cuts in FY10? Further equity issues are likely as impairment charges remain elevated through FY10. Single digit loan growth is likely with demand for mortgages offsetting subdued business credit demand. Net interest margins are recovering from 10 years of decline. Capital ratios appear adequate. A recovery in cash earnings will eventuate when the elevated credit impairment charges start to decline – FY11. Medium to longer-term they provide reasonable value but have probably overshot in the near-term.

Widespread temporary government incentives revived the housing sector. The combination of the First Home Owners Boost and various reductions in stamp duty lifted activity in the sub-$600,000 market. The extent to which this lifts activity in new construction is critical for building material stocks where pricing has been rational as volumes fell and now increased volumes will drive an earnings recovery. Unfortunately the incentives are temporary and a typical cyclical upswing appears illusory particularly if mortgage rates start rising: an interesting dilemma then for the Reserve Bank. Non-residential construction is in the doldrums while government infrastructure spending will help demand for construction materials. Not a favoured sector at current prices.

Healthcare remains on our preferred list. Private health insurance is almost in the necessity category and underpins our positive stance on private hospital operators Ramsay Healthcare and Healthscope. We like CSL and Cochlear due to unique international competitive positions. We downgraded pathology stocks following likely changes to the competitive environment.

Retail is a mixed bag. Household consumption is expected to be under pressure for a couple of years as the de-leveraging process runs its course. From growth of 4.0% in 2006/07 the RBA forecasts a 0.25% contraction in 2009/10. Credit cards have been cut up and horns pulled in. Personal credit is actually falling as some consumers, fearing unemployment, focus on debt repayment. Over geared household balance sheets have to be repaired just the same way as those of stretched

AREITS and corporates. They had the equity market to tap. Households can only tap earnings or sell assets. It takes time and so consumption will be below trend for a little while. Discretionary retailers have bounced strongly reflecting the levels reached in the sell-off late 2008 / early 2009. Consolidation or even drifting lower is our call for the next six months. Necessity retailers – defensive – have underperformed but did not suffer in the sell-off. We still like Woolworths, Metcash and The Reject Shop.

Both the mining and energy sectors performed strongly over the past six months. They were a significant force in dragging the market off the March lows. How they perform over the next six months is questionable but over the next five years likely strong out performance. There is little doubt major Australian resource companies are well placed over the long-term with long life Tier 1 assets operating generally in the bottom quartile of the cost curve. The world has an insatiable appetite for energy in its various forms. Australia is well placed in the potential higher growth segments of gas/LNG and uranium. In the former Woodside (WPL) is our strong preference with Santos (STO) our second pick. BHP-Billiton (BHP) and Rio Tinto (RIO) provide diluted exposure to uranium with Energy Resources (ERA) a direct exposure.

Leading global diversified mining groups BHP and RIO provide exposure to an attractive portfolio of first class assets. Current prices offer attractive medium-term entry points with a slight leaning toward RIO. Preference in the coal space is New Hope Corporation (NHC) while the slimmed down Oz Minerals (OZL) provides exposure to copper. Nickel is a flighty metal and exposure via Western Metals (WSA) and Independence Group (IGO) is probably more for traders than investors.

As mentioned in our Forecast 2009 in YMW 48 of December 2008 – "We are not locked into a defensive strategy. The market is dynamic and as investment conditions improve we will be flexible in moving onto the front foot. The need for investment income – a safe and secure dividend stream – to counter falling interest rates on bank deposits will become increasingly important. A defensive approach should provide both the required income particularly after grossing up for franking and comfort after the ravages of 2008." M

Banks – Time for a breather

ANZ Bank ANZ	
Price	$16.00
Recommendation	**Hold/Subscribe**
Accumulate Below ($)	14.30
Buy Below ($)	12.60
Last Review	28/05/09 (YMW20)
Business Risk	**Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	16.80

Bendigo Adelaide Bank BEN	
Price	$6.11
Recommendation	**Hold**
Accumulate Below ($)	5.90
Buy Below ($)	4.70
Last Review	04/06/09 (YMW21)
Business Risk	**High**
Price Risk	Medium
Moat Rating	None
Fair Value ($)	6.75

Major bank stocks rallied strongly from their late January lows. Deep pessimism about the global financial crisis and world recession slammed bank share prices in a UK and US equivalent of the Great Crash of 1929–32. The rally took off when US banks surprised with predictions of profits for the March quarter. Stress test results and subsequent capital raisings were well-received. Only around US$75bn in extra capital needed to be raised from the market and over half the banks did not require more capital to survive the stress scenarios. US bank credit default swap spreads declined sharply after the test results. A number of the capital raisings were oversubscribed and there was sizeable non-guaranteed bank debt issuance. This was a precondition for the repayment of TARP funds, which a good proportion of major US banks have now done.

We can probably now say that the worst of the global credit crisis has ended. Much of the rally in Australian bank stocks was due to the unwinding of large discounts for risk. The majors have each raised domestic non-guaranteed debt and we now see the first non-guaranteed raisings offshore. From now on Australian bank share prices should largely reflect domestic earnings drivers, with overnight news about offshore banks to fade in significance.

Australian banks are in reasonable shape but face declining credit growth, asset quality issues and elevated impairment charges. Improved margins will help. We are comfortable with our current earnings forecasts and valuations. ANZ, CBA and NAB are currently in the Hold zone. Westpac is in the top end of the Accumulate zone. Subscribers have had time to buy banks in our Buy ranges and in general we wouldn't be buying at current prices. By all means top up if the share prices retreat into our Buy/Accumulate price zones. Looking forward we anticipate a solid recovery in cash earnings as the level of credit crisis induced impairment charges decline from the elevated FY09 and FY10 levels estimated around $11–12bn respectively for the major banks. **Refer to our report – *Straw Hats in Winter – Banks Undervalued 20–25%* – of 27 February on our website.**

The bull case for the major banks centres on their greater market share and pricing power following the demise of securitising non-bank lenders in the credit crisis and the withdrawal of some overseas

Bank of Queensland BOQ	
Price	$8.24
Recommendation	**Reduce**
Accumulate Below ($)	6.10
Buy Below ($)	5.25
Last Review	16/04/09 (YMW14)
Business Risk	**High**
Price Risk	High
Moat Rating	None
Fair Value ($)	7.00

Commonwealth Bank CBA	
Price	$37.03
Recommendation	**Hold**
Accumulate Below ($)	35.80
Buy Below ($)	32.60
Last Review	14/05/09 (YMW18)
Business Risk	**Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	38.80

banks from the domestic corporate market. The majors are writing 90%+ of new home loans and are dictating terms to corporate Australia. Only the largest corporates are able to raise debt in alternative markets, for example Asia. The increase in pricing power is obvious with variable loan rates moving independently of the Reserve Bank's cash rate as banks claw back the increased cost of long-term wholesale funding. CBA's recent unilateral 10 basis point increase in its standard variable rate, which will restore net interest margin (NIM), was the latest example. Although it represented a catch-up to the SVRs of peers it will give peers confidence to lift their own rates independently of higher official interest rates. Lending to some sectors effectively ceased particularly commercial property. Two of the majors at least in some cases are reputed to be taking a hard line on stressed corporate structures showing little appetite for workouts comfortable instead taking a hit up front.

CBA copped a political backlash on lifting its variable rate. The risk of more criticism or even less favourable government policy towards banks now the credit crisis is over should stop banks from extreme gouging. Obviously expecting the blast from politicians, CBA released a 13-page presentation explaining the increase in its average funding costs since the crisis began in mid-2007. Although the picture improved since March, the cost of long-term wholesale funding increased by over 1.1% since June 2007. Strong competition for deposits drove up the cost of deposit funding. The cost of funding the home loan portfolio will continue to rise as older cheap term funding matures and is replaced by more expensive new term funding.

So some of the gains in pricing power will be lost recovering higher funding costs. The bullish point is more the end of price competition from non-banks, which saw net interest margins (NIMs) more than halve from 4.5%+ in the late 1980s to around 2.0% in 2008. Major banks should be able to gradually rebuild their NIMs, particularly if they reduce their holdings of prudential liquidity. NIMs appear to be bottoming with FY08 looking like the turning point. This will help offset the impact slowing loan growth.

Average NIM for the four major banks

Year	NIM (%)	Year	NIM (%)	Year	NIM (%)
1997	3.42	2001	2.88	2005	2.38
1998	3.21	2002	2.78	2006	2.31
1999	3.10	2003	2.65	2007	2.21
2000	2.96	2004	2.48	2008	2.08

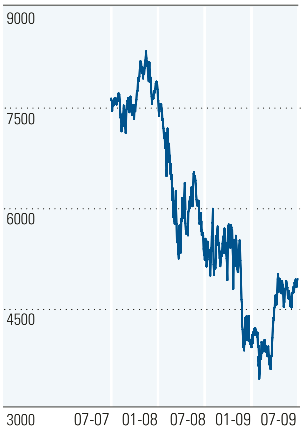
Credit growth, one of the main determinants of bank earnings, is correlated to economic growth. Through-the-year system credit growth fell from 16.2% to January 2008, 6.8% in December 2008 and 4.6% to April 2009 as the recession took hold. Credit to business fell sharply, from a peak of 23.9% in December 2007 to just 3.5% in April 2009 as business investment slumped. Personal credit is actually falling as some consumers, fearing unemployment, focus on debt repayment. Housing credit has slowed but is supported by various temporary government incentives. It should continue to recover while mortgage rates remain low and housing affordability reasonable. The Reserve Bank forecasts a gradual economic recovery to begin later this year. If this happens, 2009 or 2010 should be the year credit growth troughs.

This should be about when the current windfall market share gains for big banks peter out and loan book growth rates again approximate the broader banking system. At a time when credit growth plunged to single-digit lows not seen since the 1991 recession, the major banks have been fortunate in lifting banking income which has helped to partially offset some of the large increases in impairment charges.

The credit crisis led to a spike in large single-name bad corporate loans; fortunately there have been no new such cases since mid-2008. Banks are currently expensing a second round of personal and SME bad debts as the recession bites. If the recession ends this year, 2009 or 2010 should be the peak of this bad debt cycle. Loan defaults lag the economy, so impairment charges will remain high well after the economic recovery begins. Uncertainty about asset quality is the main current restraint on bank share prices.

All major banks raised equity to provide enough capital to help support market share gains from non-banks and offset the impact of sharply higher impairment charges. It is no coincidence the majors raised some $10bn in new equity, excluding DRPs, approximately equal to the estimated collective FY09 impairment charges. Further equity raisings over the coming 18 months, for the same reasons, are likely and could dampen share prices. Today Tier 1 capital ratios average nearly 9% and we expect regulatory pressure to keep them above pre-credit crisis levels around 7%. This step increase in shareholders' funds will keep the average return on equity well below the 20% achieved prior to the credit crisis. This will be reflected in share prices.

Australian Banking Index



Source: Morningstar Analysts

National Aust. Bank NAB	
Price	$21.45
Recommendation	**Hold**
Accumulate Below ($)	21.45
Buy Below ($)	18.75
Last Review	30/04/09 (YMW16)
Business Risk	**Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	26.80

Westpac WBC	
Price	$19.21
Recommendation	**Accumulate**
Accumulate Below ($)	19.60
Buy Below ($)	18.50
Last Review	07/05/09 (YMW17)
Business Risk	**Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	21.80

Interim dividends for the September-balancing banks were down 20–25% with payout ratios trimmed as capital preservation issues came to the fore. CBA's December-half interim was flat but the final will be down 25%. There will be no early return to pre-crisis, pre-recession dividend levels. Once banks are able to resume steady earnings growth, dividends should inch higher from FY09 levels.

Having overseen a substantial reduction in competition in banking, the ACCC ruled out approval for any further bank M&A unless necessary to reduce systemic risks. This was the reason for approval of CBA's takeover of Bankwest. Additionally the Four Pillars policy is entrenched in Canberra. Both situations mean shareholder returns will have to come from organic earnings growth. Mooted deals like a merger with a regional bank or an acquisition of Suncorp's bank would appear to be off the agenda for the majors. A demerger of Suncorp would be possible if SUN's proposal to own its bank via a non-operating holding company succeeds.

All four majors face specific challenges. CBA continues to bed down Bankwest and deal with the Storm Financial collapse. Westpac is integrating St George having paid an elevated price and trying to maximise synergy benefits while operating a multi-brand bank. National has struggling UK operations and exposure to special purpose vehicles. ANZ is dealing with a further deterioration in 2H09 impairment charge and the possible acquisition and integration of Asian businesses from Royal Bank of Scotland.

Regional banks are in a more difficult position. Their market share is slipping while second tier credit ratings make funding costs more expensive relative to the majors under the government guarantee framework. Asset quality is suffering as earlier aggressive lending policies in pursuit of market share come home to roost. The high cash multiple on which the Bendigo Bank – Adelaide Bank merger was formulated impacts their ROE. We recently removed our Narrow moat ratings on both Bendigo and Adelaide Bank (BEN) and Bank of Queensland (BOQ), questioning their ability to generate returns above their cost of capital. We still think provisioning levels are inadequate and barely meet minimum regulatory requirements. Our recently revised earnings estimates assume larger loan losses over the next two years. There is a remote possibility of BEN, BOQ and Suncorp (SUN) coming together to merge their banking operations, though the likelihood is difficult to predict given the differences in business strategy, culture and management issues. Individual business risk for all three regional banks remains High.

Analysts: Peter Warnes, David Walker, Peter Esho

Insurance – Stick with QBE

Insurance Aust. Group IAG	
Price	$3.45
Recommendation	**Hold/ Subscribe to SPP**
Accumulate Below ($)	3.25
Buy Below ($)	2.75
Last Review	12/03/09 (YMW10)
Business Risk	**High**
Price Risk	High
Moat Rating	None
Fair Value ($)	3.50

The 2007–2009 years were very challenging for the domestically focused general insurers, IAG and Suncorp (SUN). They had to deal with a high level of catastrophe claims and enormous investment market volatility and the reason why we rate business risk as high for both stocks. QBE's international general insurance and reinsurance operations provide greater diversification with Australian catastrophe claims having little impact on the group.

But unqualified and dubious management made their travails much worse. SUN overpaid for Promina, a defensive acquisition with no revenue synergies. While Promina was neatly integrated, the size of the task distracted management from the real priority: reducing SUN's reliance on long-tail reserve releases to smooth catastrophe claims above allowances. IAG similarly wasted precious management time and a large chunk of shareholders' funds on an offshore acquisition drive culminating in a disastrous move into UK mass-market insurance.

Having career bankers in charge of insurance companies doesn't work. Hopefully the mistake won't be repeated. IAG shares outperformed the market in 2008 as well-regarded insurance veteran Mike Wilkins implemented sensible reforms. In SUN's case it also didn't help having a career banker in charge of a bank. The headlong rush to lend to Babcock & Brown and property developers at the top of the cycle left a huge bad debt bill. SUN is currently drifting, leaderless and without a strategy. The CEO has gone and now the Chairman and most of the Board need to leave as well.

SUN shares rallied on the better outlook for banks and the rejuvenated balance sheet following February's $1bn+ equity raising. IAG also raised equity and both adopted more conservative dividend policies to reflect lower profitability and

QBE QBE	
Price	$18.85
Recommendation	**Buy**
Accumulate Below ($)	20.90
Buy Below ($)	19.15
Last Review	04/06/09 (YMW21)
Business Risk	**Low-Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	25.25

Suncorp-Metway SUN	
Price	$6.42
Recommendation	**Hold**
Accumulate Below ($)	5.65
Buy Below ($)	4.40
Last Review	04/06/09 (YMW21)
Business Risk	**Medium-High**
Price Risk	High
Moat Rating	None
Fair Value ($)	6.30

preserve capital. They also increased reinsurance cover, which should reduce earnings volatility.

SUN now allocates no shareholders' funds to equities while IAG allocates about a third, down from 90%+. This increases exposure to fixed interest and, thus, movements in interest rates, bond yields and credit spreads. Rising rates and yields reduce fixed interest capital values but also provide opportunities to invest premium revenue at higher yields. Rising bond yields are not necessarily an outright negative if credit spreads stabilise or diminish.

Management of both companies became more conservative over the last year. Much less damage would have been done to shareholders had this approach been adopted earlier. The best insurance stock is one which avoids unprofitable risks and steadily accumulates reserves ahead of cyclical downturns in premium rates and years of above-average claims costs. If SUN and IAG start to manage themselves like our business risk ratings might be lowered.

The decline in commercial premium rates in 2006–08 made life much harder. Premium revenue growth rates and insurance margins should improve now the downturn is largely over. Pricing in personal lines remains rational and both insurers are recovering elevated claims costs and lost investment income through higher premium rates.

To improve transparency and make it easier for the market to value the SUN Board has proposed switching from the current bank holding company, which owns the general insurer and the wealth management operations, to a non-operating holding company, which would own all three businesses. This would also make a demerger legally simpler. With the ACCC ruling out further bank M&A involving a major, a demerger could be the only way for SUN to abandon the failed cross-selling model and become a specialist general insurer.

Catastrophe claims are impossible to predict. Assuming they revert to some kind of mean after two extreme years it's not hard to see SUN and IAG shares rallying over the next 18 months, particularly if investment markets become more supportive. The cyclical upturns in personal and commercial lines premium rates should work their way to the bottom lines. IAG finally has the right kind of management. SUN still needs stable management and a viable model. Hopefully both companies have put their days of serious management errors behind them.

QBE is an entirely different animal – a highly profitable business, extremely well managed by a team of long-term conservative insurance professionals. Insurance has enough embedded risk that does not need to be increased by an over zealous investment strategy. An underwriting profit coupled with a low risk approach to investment results in significant profitability and QBE out performing most peers in all markets. QBE remains on the look out for acquisitions which drives future premium growth. With about 75% of all business written offshore the strength of A$ is currently a drag.

Analysts: David Walker, Peter Warnes

Non-bank Financials – Cooper Review Uncertainty

It looks like equity markets saw their lows in March. Normally, with the market coming out of a bear phase, we would gradually but confidently upgrade our earnings forecasts and valuations for the non-bank financials we cover. In the end their main earnings drivers are the level and direction of equity markets, since these affect funds under management and administration, the propensity of retail investors to invest and trade, and capital adequacy. And if equity markets do keep rallying then we will upgrade.

This time however we will have to allow for the increasing likelihood of adverse legislative and regulatory reform of the retail superannuation fund aggregator business model. The head of the Federal government's forthcoming review of the superannuation sector has made aggressive, critical comments which suggest a radical shakeup of the industry's revenue model is being considered. ASIC deputy chairman Jeremy Cooper last week said "There are too many layers, too many moving parts and too many people clipping the ticket, and we're trying to get to the bottom of all this. There is a structural problem with the way fees are charged on an asset-based or percentage basis. Investment management fees increase, rather than decrease, as the size of the assets under management increase. This is in spite of the economy of scale that a large fund brings. This feels like it is not the right setting for super."

The review has not begun yet and there is no way to know its outcomes, but the outlook is ominous. The low-fee, union-affiliated industry fund sector

ASX ASX	
Price	$35.30
Recommendation	**Hold**
Accumulate Below ($)	32.80
Buy Below ($)	28.90
Last Review	30/04/09 (YMW16)
Business Risk	**Medium**
Price Risk	Medium
Moat Rating	Wide
Fair Value ($)	34.70

has successfully lobbied the Rudd Labor Government to expose the multiple layers of fees which detract in scale from super balances invested elsewhere, as well as the conflicts created by owning manufacturing, packaging and distribution in the same house. At the very least there will be ongoing government pressure to phase out commissions, reduce fees and simplify fee structures, at worst there will be mandated reforms. Most likely is a negotiated agreement with the industry but it's hard to see this being more favourable than the current fee gravy train.

We are monitoring the situation closely and will review our earnings forecasts and valuations for the non-bank financials. We might apply an uncertainty discount for the risk of adverse reform. Companies in the sector tend to be proxies for the share market. A rising market lifts assets under management and administration and influences the flow of funds. Fee income has tended to follow asset levels, however the outcome of the Cooper Review may see this relationship change significantly.

ASX is not a fund aggregator, so unaffected by the super review. ASX remains worth holding for its exposure to the long-term growth in the Australian equity market.

Analyst: David Walker

Healthcare – Private health insurance a necessity

CSL CSL	
Price	$31.60
Recommendation	**Buy**
Accumulate Below ($)	43.00
Buy Below ($)	35.00
Last Review	11/06/09 (YMW22)
Business Risk	**Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	43.00

Cochlear COH	
Price	$55.93
Recommendation	**Accumulate**
Accumulate Below ($)	60.00
Buy Below ($)	50.00
Last Review	12/02/09 (YMW06)
Business Risk	**Low**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	60.00

Ramsay Health Care RHC	
Price	$11.80
Recommendation	**Accumulate**
Accumulate Below ($)	12.50
Buy Below ($)	10.50
Last Review	28/05/09 (YMW20)
Business Risk	**Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	12.50

The public healthcare system is reaching a crisis point after a decade of under-funding. Demand for care is rising, causing waiting lists for procedures to grow, while a lack of investment in facilities and training leads to a shortage of skilled specialists and equipment. The differences between the public and private hospital systems are vast. Public has evolved into a bureaucratic mess of policy and procedure while the invisible hand of market efficiency compares private hospitals to hotel like services. This differentiation explains why participation in private healthcare insurance holds up despite a contraction in economic conditions. Many view private healthcare insurance as a necessity, while the Lifetime Health Cover policy penalises those who leave the system.

The introductory of Lifetime Cover in 2000 explains the jump in private health insurance participation from around 30% to the mid 40% level. Lifetime Cover means those older than the age of 30 entering a private health insurance scheme pay a 2% surcharge per year above the base cost of membership. For example, a 40 year old pays 20% more than a 30 year old. Entry age becomes the important date in setting the cost of membership. So if you had been a member since the age of 30 and leave at 40 and then return six months later you lose your 20% cost discount. This scale up in cost is an incentive to retain membership. Private health insurance participation is critical in ensuring capital is available for the private healthcare service industry.

Kevin Rudd's Labor government established the National Health and Hospital Reform Commission. The role of the commission is to develop a long-term health reform plan for Australia. An interim report focuses on the importance of individuals taking responsibility and building good health. Preventative healthcare through community education is a top priority. The focus will be on the introduction of primary healthcare centres as the first port of call for patients, to help ease the pressure and demands on hospitals. Discussion and public feedback will continue and today it remains far from clear exactly what legislative changes will be proposed. The commission, which consists of public servants with one exception, emphasises the importance of retaining the balance of public and private financing, which it regards as one of the strengths of the current system.

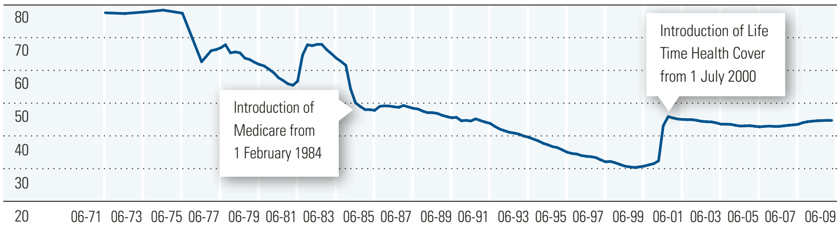
The aging population is an issue cited as an important reason healthcare is a sensible investment. Many private operators are only now recording noticeable increases in demand from the older generation. Private hospital operators expect years of under-investment in the public system will see the government follow the lead of the UK and outsource work to the private sector, to address the political backlash from escalating waiting lists for standard procedures.

The private hospital industry is largely consolidated into two operations with **Ramsay Healthcare (RHC)** the largest service provider which holds most of the tier one private hospitals, and **Healthscope (HSP)**, holding a newer portfolio of hospitals which are building occupancy levels. Both companies are consolidating previous acquisitions which lead to a lower unit cost of service and profit growth. Bigger scale enables these businesses to borrow larger

Healthscope HSP	
Price	$4.44
Recommendation	**Accumulate**
Accumulate Below ($)	4.60
Buy Below ($)	4.10
Last Review	26/02/09 (YMW08)
Business Risk	**Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	4.60

amounts of capital to reinvest by expanding hospital capacity. Expanding a hospital which has an established presence within a community brings rapid returns on invested capital. A new hospital wing is quickly filled, which further establishes the importance of the facility as a regional hub for specialist healthcare. We expect both of these companies to perform well in the next few years.

Insured Persons as a % of Population



Source: Australian Bureau of Statistics

Changes to the 2009 government budget means the competitive landscape within the Australian pathology industry is likely to change. We downgrade our outlook for both Sonic Healthcare (SHL) and Primary Health Care (PRY) because of industry changes which make it easier for independent medical centres to compete and for the government to restrict industry funding through its annual review.

The Obama administration is overhauling the US healthcare industry. Obama aims to open up healthcare for all by introducing a government-subsidised insurance scheme but just how it evolves through the Representatives and Senate is up in the air. **CSL (CSL)** says at this stage it does not believe the administration's initiatives will make a material impact on its profits. Both CSL and Cochlear are companies we like because of their unique international competitive positions. M

Analyst: Tim Montague-Jones

Retail – Muted consumer demand for several years

Billabong Intl BBG	
Price	$8.37
Recommendation	**Hold**
Accumulate Below ($)	7.40
Buy Below ($)	6.70
Last Review	21/05/09 (YMW19)
Business Risk	**Medium**
Price Risk	High
Moat Rating	Narrow
Fair Value ($)	7.40

David Jones DJS	
Price	$4.00
Recommendation	**Hold**
Accumulate Below ($)	3.30
Buy Below ($)	2.90
Last Review	14/05/09 (YMW18)
Business Risk	**Medium**
Price Risk	High
Moat Rating	None
Fair Value ($)	3.60

The Retail sector faces an uncertain demand environment following the abrupt end to a decade or more of elevated consumer spending. This primarily reflects falling values of household assets and the fear of job loss, against a backdrop of increased household debt. Household net financial wealth fell by around one third over 2008 and despite recent gains the share market is still around 40% below 2007 peaks. Households are paying down debt and rebuilding savings. The de-leveraging process will take time. Cash to pay down debt or boost savings can't be plucked from thin air – it has to be earned.

Household consumption grew at 4.0% in 2006/07, 3.7% in 2007/08 and after slowing sharply in 2008/09 to an estimated 1.0%, the RBA expects household consumption to contract by 0.25% in 2009/10. "This is a mild fall given the substantial headwinds being faced by the household sector, and significantly less than that being experienced by most other advanced economies. While the household sector has been buffeted by a series of negative shocks stemming from the global recession, government stimulus packages are providing considerable support to household consumption. In the absence of this action, the contraction would be much more severe."

"A large amount of policy stimulus is helping to support household consumption. The Economic Security Strategy and the Nation Building and Jobs Plan will collectively add $19.7 billion to household incomes, and the pension increase announced in the 2009/10 Budget will also add significantly to household incomes and help support consumption. These stimulus payments are expected to support a higher level of consumption over the [next two years], with the bulk of this support coming in 2009, when the economy is at its weakest (Chart 1). This stimulus is estimated to add 1¼ per cent to the level of household consumption in 2008/09 and 2009/10. In the absence of this stimulus, household consumption would have contracted sharply, as it has in other countries. Mortgage interest rates have also been cut to their lowest level in more than 40 years, substantially raising household disposable income."

In March 2009, by the RBA's calculation, the fall in borrowing rates reduced the debt servicing burden of the household sector by approximately five per cent of household disposable income.

There is strong evidence stimulus payments provided a significant boost to household consumption. Retail trade in March 2009 was 4.5 per cent higher than prior to these payments and sector employment rose in February 2009 for the first time in over a year.

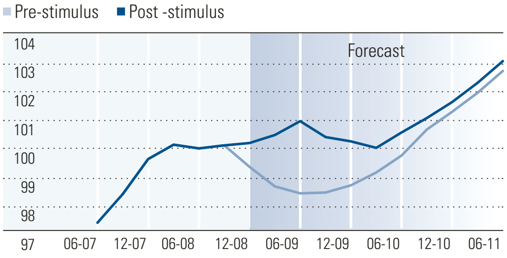
JB Hi Fi JBH	
Price	$14.94
Recommendation	**Sell**
Accumulate Below ($)	9.45
Buy Below ($)	7.90
Last Review	28/05/09 (YMW20)
Business Risk	**High**
Price Risk	High
Moat Rating	None
Fair Value ($)	10.15

Metcash MTS	
Price	$4.09
Recommendation	**Accumulate**
Accumulate Below ($)	4.15
Buy Below ($)	3.50
Last Review	04/06/09 (YMW21)
Business Risk	**Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	4.55

Wesfarmers WES	
Price	$21.90
Recommendation	**Hold**
Accumulate Below ($)	18.80
Buy Below ($)	17.20
Last Review	14/05/09 (YMW18)
Business Risk	**Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	21.90

Woolworths WOW	
Price	$25.49
Recommendation	**Buy**
Accumulate Below ($)	27.45
Buy Below ($)	25.95
Last Review	23/04/09 (YMW15)
Business Risk	**Low**
Price Risk	Medium
Moat Rating	Wide
Fair Value ($)	32.05

Chart 1: Stimulus effect on household consumption (Index Sept 08 = 100)

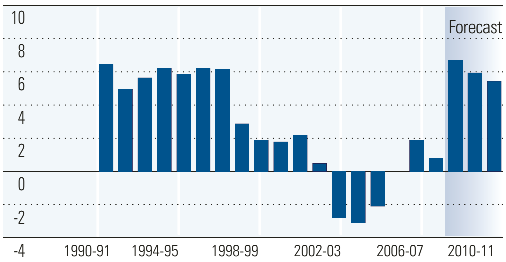


Source: ABS and Treasury

The RBA expects household consumption growth to strengthen to a still below trend 1¾ per cent in 2010/11. It expects the combined impact of lower household wealth, slower income growth, and still rising unemployment to subdue household consumption for "some time to come". Other dampening factors include a likely bottoming of housing loan rates and petrol prices, and probable end of government handouts to consumers. Nor is it clear house prices below $500,000 will continue to recover once the temporary incentives are withdrawn. The top end outlook remains subdued at best. Tax cuts from 1 July will provide some help to low income earners.

Households rebuilding balance sheets will ultimately facilitate a recovery in household consumption once the process is complete. The RBA forecasts the household saving ratio to average 6¾ per cent in 2008/09 and remain at a high level over 2009–2011 (Chart 2). The Bank's forecast period ends in 2011 but given a decade of weak saving up to 2008, we expect the period of balance sheet restoration to continue for several years after 2011.

Chart 2: Household saving ratio (%)



Source: ABS and Treasury

We see downside risk to consumer demand for at least a year. Somewhat better conditions should emerge in FY11 but hardly "strong" given a backdrop of still significant global economic challenges and ongoing household deleveraging.

The retail sub-sectors can have very different industry and investment characteristics. At the one end are supermarket retailers such as **Woolworths (WOW)** and Coles (**Wesfarmers WES**) which sell mostly non-discretionary consumer staples, and at the other, upmarket apparel retailers such as Oroton whose products are wholly discretionary. A most important investment consideration is the consistency of profit generation. Our business risk rating we supply for each stock includes this assessment. Investors pay a premium for low business risk, the more so the more uncertain the economic outlook. Grocery retailing is highly resilient so investors pay a premium for supermarket exposure, although the majors WOW and particularly Coles (Wesfarmers) are not pure supermarket plays.

While staples generate the majority of Woolworths' earnings, roughly 13% come from more discretionary segments such as clothing, toys, music and housewares (BIGW), consumer electronics (Dick Smith) and Hotels. The dilution of supermarket earnings is greater at WES where grocery, liquor and petrol represent 35% of forecast FY10 EBIT. Metcash provides purer supermarket exposure, but as a wholesaler to independents.

Woolworths (WOW), **Metcash (MTS)** and The Reject Shop (TRS) are the only retail stocks where we have positive recommendations. Despite many years of above average growth, we continue to view WOW as enjoying both defensive and growth attributes. This deserves a premium valuation, yet a fully franked yield of 4% is attractive in the current climate of low bank deposit rates. Some analysts doubt whether EPS can continue growing at well above GDP rates due to the company's size and a strengthening competitor in Coles. But with massive power over suppliers, high returns on capital and exceptional cash flow WOW's earnings momentum seems assured for the next five years. A highly developed and refined business model continues to position it well ahead of Coles in terms of competitive strength. Coles has years of business infrastructure investment and improvement to undertake before it will contemplate attacking WOW. Since raising capital WES has bounced 50% off its lows, well into our Hold zone.

Independents continue to increase market share, benefiting from changes in industry dynamics and consumer trends. Well managed Metcash is well placed to benefit from this shift and future growth will be driven by a combination of store expansion and gradually increasing sales per square metre of retail trading space. We expect EPS to grow in FY10 and FY11 by 8.8% and 12.8% respectively and forecast an FY10 fully franked dividend yield of 5.6% fully franked.

The Reject Shop fills an interesting space. It is one of the few – perhaps the only – successful discount variety retailers, a segment littered with failure. Success comes from management ability to identify and source high turnover everyday products. Customers embrace the concept with compound average growth in sales of 16.6% over the past five years. We estimate EPS growth in FY09 and FY10 of 9.7% and 11.7% respectively with a forecast FY10 fully franked dividend yield of 5.0%.

The share prices of a number of domestically focused discretionary retailers staged very significant recoveries after terrified investors desperately sold them in late 2008 / early 2009. **David Jones (DJS)** almost doubled, Super Cheap Auto (SUL) is up 80% while Harvey Norman (HVN) is 50% higher. The strength of the rally indicates a somewhat surprising level of investor confidence given a still very weak global economic outlook and the degree to which recent consumer demand strength owes much to government stimuli. But expectations had reached a black abyss, from which we have withdrawn. Australia could recover strongly in FY11 and beyond but the likelihood of an increased household savings rate suggests muted growth from discretionary retailers for an extended period.

Typically smaller retailers display high operating leverage so falls in revenue are magnified at the profit level. With the government stimulus exhausted, some discretionary retailers could see sharp falls in profit in FY10. Global players with less exposure to the relatively strong Australian economy are already feeling the pinch. We forecast **Billabong's (BBG)** FY09 EPS to be 21% below FY08 and to fall a further 14% in FY10. The rebound in the A$ – to the extent it persists – could partially counter falling revenue, assisting margins via lower cost of imported product. It also penalizes translation of offshore profits. A glut of Asian manufacturing capacity including an urban labour surplus will also place downward pressure on costs.

Consumer electronics has been a strong discretionary segment, exemplified by **JB Hi Fi's (JBH)** continued exceptional growth. We estimate FY09 NPAT will be 45% higher than FY08 at circa $92m, after similar growth in the previous two years! Consumers have spent on upgrading home entertainment technology to utilise cable TV and the Internet. Among other drivers, this trend reflects trading down to a form of entertainment cheaper than many alternatives, and also a desire to cocoon from the "harsh outside world." While we think the trend has a way to run, we consider JBH expensive at current levels, with no buffer for disappointment. Other companies benefiting from this trend, but without JBH's concentration, include HVN and WOW, the latter via Dick Smith.

Analysts: James Cooper, Peter Warnes

AREITs – Cautious optimism after recapitalisations

After a tumultuous year of falling property values and collapsing unit prices, good quality AREITs finally appear to be moving into a period of stability. Large capital raisings at significant discounts have repaired balance sheets, cutting risk and triggering a positive market re-rating.

We are now cautiously optimistic about the outlook for AREITs going into FY10 with a range of positive signs. Most trusts appear relatively good value, having priced in further falls in underlying property values. Healthier balance sheets and thawing capital markets remove the risk of en masse forced asset sales. We remain wary on a number of fronts.

AREITs proved to be the riskiest asset class over the last couple of years, underperforming all other indices including high-risk sectors like small caps and discretionary retail. Underlying property is still performing relatively well so the plight of AREITs can mostly be attributed to management overusing debt and overpaying for assets during the boom. Part of the cause of this behaviour is the structure of base and performance fees which encourage managers to increase assets under management and take more risks, creating a conflict of interest with security holders. We are disappointed that fee structures have not been reformed.

Earnings and distribution outlook

AREITs consolidate four principal sources of revenue: rental income, funds management fee revenue, development management fee revenue and residential development profits.

The occupier side of the property market remains under pressure as the economy deteriorates, rising unemployment damages office occupancy and retail spending falls so hurting shopping centre occupancy. Perth office properties will be

CFS Retail Property Trust CFX	
Price	$1.63
Recommendation	**Hold**
Accumulate Below ($)	1.55
Buy Below ($)	1.40
Last Review	14/05/09 (YMW18)
Business Risk	**Low-Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	1.70

Dexus Property DXS	
Price	$0.71
Recommendation	**Accumulate**
Accumulate Below ($)	0.75
Buy Below ($)	0.65
Last Review	23/04/09 (YMW15)
Business Risk	**Low-Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	0.90

GPT Group GPT	
Price	$0.50
Recommendation	**Hold**
Accumulate Below ($)	0.50
Buy Below ($)	0.45
Last Review	18/06/09 (YMW23)
Business Risk	**Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	0.55

Mirvac Group MGR	
Price	$1.15
Recommendation	**Accumulate**
Accumulate Below ($)	1.25
Buy Below ($)	0.90
Last Review	11/06/09 (YMW22)
Business Risk	**Medium**
Price Risk	High
Moat Rating	None
Fair Value ($)	1.50

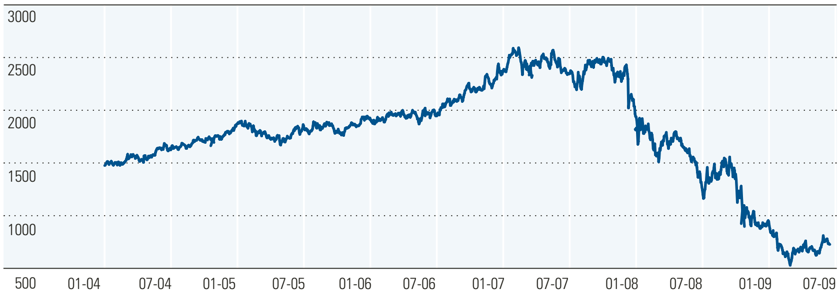
particularly hard hit over the next few years as demand retreats at the same time as significant new supply arrives. Brisbane and Canberra face similar headwinds while Sydney, Melbourne and Adelaide should hold up better as new building activity has not been excessive.

With leases generally five years or longer, it is possible that the economy will recover before the majority of existing leases expire, with fixed annual rent increases providing inbuilt revenue growth. Certainly, those tenants renewing leases in the downturn will seek lower rents and insolvencies will lead to some leases terminating, but these should be a minority. The alleged explosion in sub-leasing will have a limited effect on AREITs as tenants are still legally committed to pay rent even if not in occupation and AREITs have limited vacant space exposed to falling market rents.

Those AREITs operating managed funds, such as **Dexus (DXS)**, **GPT Group (GPT)** and Goodman Group (GMG), benefit from recurrent low-risk base funds management fees which are unlikely to be significantly affected in the current downturn. Upside from performance fees, transaction fees and fees for the creation of new funds will be postponed to the medium term and some risk to fee revenue exists where managed funds have high debt and may need to sell assets. Similarly, development management fees will be limited until markets recover and this is reflected in our stock valuations.

AREITs such as **Mirvac (MGR)**, **Stockland (SGP)** and Australand (ALZ) have large exposures to residential development which has become the darling of Commonwealth and State Government Treasurers. First home owner grants and other stimulus initiatives are positive for the residential development industry and developers benefit from repackaging product for this market. Continued support for first home owners by Government translates into continued support for AREITs.

Australian Property Trusts Index



Source: Morningstar Analysts

While AREIT revenues are relatively robust, operating profit may be cut by rising interest costs as debt packages are renewed and by continued instability from foreign exchange. Many trusts reduced FX hedging to limit the impact of fluctuating currencies on gearing levels, but this comes at the expense of greater volatility of earnings and net asset backing.

Traditionally, AREITs offered stable or rising earnings and distributions but such stability is unlikely to feature in the year ahead. Those AREITs comprising only a property trust must distribute taxable income to maintain their tax status, but there is some wriggle room. Those comprising a stapled security may decrease distributions further by retaining corporate earnings.

Balance sheet outlook

AREITs are heavily reliant on capital with most major trusts undertaking one or more discounted equity raisings over the last year to bring gearing down to manageable levels. With the stock market becoming weary of capital raisings and AREITs having to offer expensive discounts to attract support, the emerging green shoots in the debt markets are especially welcome.

While banks appear reluctant to renew maturing debt, this is at the cost of high interest rates and steep up front charges. Some trusts, such as GMG, have sought debt refinancing outside the traditional banking sector but at considerable cost through the provision of stock options. But, the recent $125m note issue by **CFS Retail Property (CFX)** indicates a willingness by bond markets to provide funding to high quality AREITs which augurs well for their medium term debt refinancing.

Mergers and acquisitions

Though press speculation about merger and acquisition activity continues, none has yet emerged and cheap buys are fading as AREITs move towards being fully valued. SGP has substantial holdings in FKP Property (FKP) and GPT. It expressed interest in a takeover of GPT, but has yet to take action.

As unit prices recover, the opportunity to acquire property portfolios at a fraction of their value through discounted AREITs diminishes. Similarly, as AREITs repair their balance sheets as has been happening apace recently, the need for a merger or asset sales to resolve capital management problems also fades.

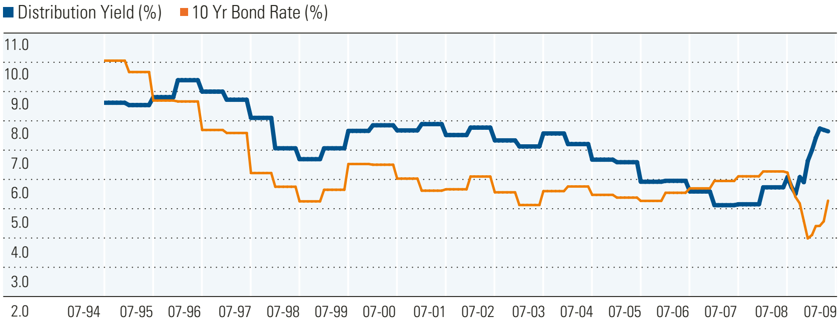
Stockland SGP	
Price	$2.96
Recommendation	**Accumulate**
Accumulate Below ($)	3.05
Buy Below ($)	2.75
Last Review	21/05/09 (YMW19)
Business Risk	**Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	3.40

Westfield WDC	
Price	$11.07
Recommendation	**Hold**
Accumulate Below ($)	11.00
Buy Below ($)	10.00
Last Review	07/05/09 (YMW17)
Business Risk	**Low**
Price Risk	Medium
Moat Rating	Wide
Fair Value ($)	12.00

AREITs continue to trade at a discount to last stated net asset backing, but that discount is slowly narrowing as property values fall and AREITs get financial risks under control. With a thawing in global credit markets and increasing sales activity, property values appear increasingly unlikely to fall as much as the more extreme forecasts. While property values should fall moderately for the next few quarters, this appears already fully priced in.

Reaching fair value?
We update a graph first used in May 2008 to justify that property was inherently overvalued. It specifically relates to CFX but is a good proxy for underlying property since the trust's unit price wasn't impacted by other problems such as a weak balance sheet. As can be seen, the commercial property boom from 2003 to 2007 pushed distribution yields below 10-year Government Bonds, an inadequate return for the additional risk. We now see a sharp reversal with CFX's distribution yield back to pre-boom levels. This provides comfort that unit price, not necessarily NTA, is close to fair value. This is the case for most AREITs in our coverage.

CFS Retail Property Trust



Source: Morningstar Analysts

The massive tide of risk facing the AREIT sector is now receding. Debt is being brought under control and the outlook for property markets is stabilising leading to the prices of high-quality AREITs such as **Westfield (WDC)**, DXS, CFX, GPT, MGR and SGP to approximate our opinion of fair value. These trusts are well positioned to withstand the global economic downturn and any weakness in security prices over the next few months should be seen as a good opportunity for income seeking investors to build stakes. AREITs with international exposure are trading at sizeable discounts to comparable domestic focussed trusts to reflect the harsher recession and more stressed property markets offshore – an appropriate discounting.

Among the smaller stocks like Valad (VPG) and Charter Hall (CHC), opportunities for significant price increases remain as the market reassesses the stocks but we caution that such AREITs are speculative situations.

As global financial, credit and property markets stabilise over FY10, the outlook for AREITs will improve accordingly. Different AREITs will benefit to different degrees, leading us to be cautiously optimistic about the outlook going into FY10.
Analysts: David Parker, Adrian Atkins

Building Materials & Products – Temporary bounce or recovery?

We retain cautious approach to these deep cyclicals. Conditions are extremely difficult at the moment. The sector should perform well once the market focuses on the likely recovery from FY10 and strengthening in FY11. Investors willing to accept greater than average risk may seek opportunities to invest on market downturns over the next 6–12 months. We have Hold recommendations on most stocks following the strong bounce earlier this year which favoured cyclicals over defensives. Small positions may be taken now in the stocks with positive recommendations: JHX below $4.25, HIL below $1.95 or ALS below $4.00.

This sector includes building and construction materials producers **Adelaide Brighton (ABC)**, Brickworks (BKW), **Boral (BLD)**, Fletcher Building (FBU) and **James Hardie (JHX)** and building products manufacturers **CSR (CSR)**, Crane Group (CRG), Hills (HIL), Alesco (ALS) and GWA International (GWT).

Earnings and dividends outlook
The upcoming reporting season will demonstrate the severity of the downturn. We expect median FY09 sector earnings to decline 26%. A recovering property market and ongoing infrastructure investment offsetting soft private commercial construction should support a modest 6% earnings rise in FY10 and a stronger FY11.

Housing starts fell 23% in the year to March quarter 2009. The downturn appears more modest than in

Adelaide Brighton ABC	
Price	$2.24
Recommendation	**Hold**
Accumulate Below ($)	1.85
Buy Below ($)	1.65
Last Review	04/06/09 (YMW21)
Business Risk	**Medium-High**
Price Risk	High
Moat Rating	None
Fair Value ($)	2.10

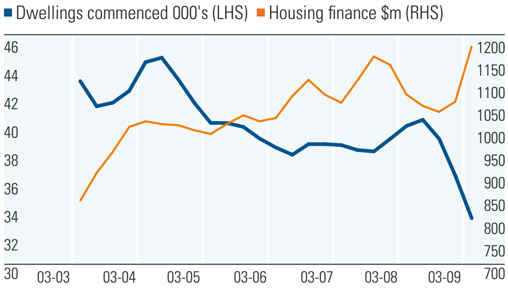
Boral BLD	
Price	$3.93
Recommendation	**Hold**
Accumulate Below ($)	3.20
Buy Below ($)	2.85
Last Review	07/05/09 (YMW17)
Business Risk	**High**
Price Risk	High
Moat Rating	None
Fair Value ($)	3.70

CSR CSR	
Price	$1.59
Recommendation	**Hold**
Accumulate Below ($)	1.35
Buy Below ($)	1.20
Last Review	18/06/09 (YMW23)
Business Risk	**Medium**
Price Risk	Medium
Moat Rating	None
Fair Value ($)	1.50

James Hardie JHX	
Price	$4.17
Recommendation	**Accumulate**
Accumulate Below ($)	4.25
Buy Below ($)	3.90
Last Review	21/05/09 (YMW19)
Business Risk	**Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	4.90

most industrialised countries as the correction began as far back as 2003. The rise in housing finance volumes in the past six months hints to an improving market. Support is provided by government stimulus especially for first home owners, low interest rates, and pent up demand. The recovery should strengthen through 2010 tempered by rising unemployment, lower household wealth, supply shortages in some areas and the prospect of rising interest rates later in the year. We expect leadership from NSW and Victoria over WA, SA and Qld which are more vulnerable to the resources decline.

Aust. Housing Starts & Finance Rolling Avg



Source: Australian Bureau of Statistics

Australian construction materials outlook is subdued for the year ahead as declining private sector activity particularly in commercial property is partially offset by government spend on rail, roads and ports. The decline in this segment has lagged housing due to longer term projects that are now rolling off.

Price rises across the material and products sector despite volume declines has been a significantly positive factor, and distinguishes this downturn from others. Pricing power reflects rational competitive activity where major players have strong positions in individual sub-markets. Most companies pushed through cost cuts and efficiency gains which position them well for earnings growth once conditions recover. Cost structures are relatively highly fixed, so revenue growth has a greater than proportionate impact on earnings.

BLD and JHX have the greatest exposures to the US. Housing starts in the US plummeted from a seasonally adjusted annual rate of 2.2m in January 2006 to 498,000 in April 2009. High inventory levels, high unemployment and lower household wealth indicate a turnaround is some way off despite low interest rates. BLD's brick, roof tile and construction materials business is likely to make losses of $120m in FY09 and $75m in FY10. JHX has maintained margins at relatively high levels despite lower sales through innovative products and efficient production.

US Housing Starts 000's Annual Rate

Source: US Census Bureau

Balance sheet and dividend outlook

Natural cyclicality necessitates conservative gearing levels, say net debt/equity below 50% and net interest cover above five times. Most materials producers entered the downturn with solid balance sheets. BLD's gearing is too high with net debt/equity around 80%, and net interest cover under two times at June 2009. Calls for an equity raising have been refused. CSR's balance sheet is weak with net debt/equity is 83% and net interest cover only three times. We would not be surprised by an equity issue, particularly one associated with the mooted Sugar spin-off. ALS' balance sheet is now in better shape following its sale of Biolab. HIL's gearing remains high.

Dividends have been cut by most companies, which along with reduced investment capex, has freed cash to support debt obligations. BKW has maintained dividends through its diversified earnings base boosted by investments and land development. Most dividends should rise modestly next year in line with improving conditions, more so 2011 as initially the companies will likely be conservative.

Mergers and acquisitions

Consolidation opportunities abound. Asset prices are well off their peaks. But Swiss company Holcim's $2bn uncontested purchase of Cemex's Australian cement operations demonstrates there aren't many local buyers willing to make large acquisitions in the current climate.

Hanson Australia could be put up for sale to reduce the debt burden of owner Germany's Heidelberg Cement, though a recent debt refinancing reduces the urgency. BLD is hamstrung by its weak capital position. ABC and FBU are more likely candidates, but they would require substantial equity issues. Victorian-based materials supplier Barrow Group has a clearer path to raise its 22% stake in ABC now that BLD's 17.6% holding has been sold. CSR may look to re-enter the building materials segment should its Sugar de-merger proceed, but it is more likely to beef up its building products business.

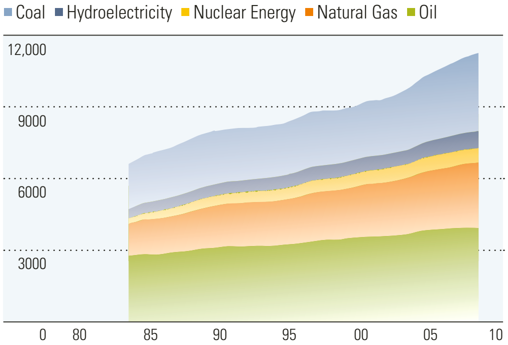
Analyst: Andrew Doherty

Energy – The world still needs it

Energy Resources ERA	
Price	$21.35
Recommendation	**Hold**
Accumulate Below ($)	17.05
Buy Below ($)	15.35
Last Review	28/05/09 (YMW20)
Business Risk	**Medium**
Price Risk	High
Moat Rating	None
Fair Value ($)	17.05

It has been an interesting period for energy markets. According to Energy Information Administration (EIA), world primary energy consumption – including oil, natural gas, coal, nuclear and hydro – grew by 1.4% in 2008 to 11.3bn tonnes of oil equivalent (toe). While the slowest growth since 2001 – the 25 year average growth rate is closer to 2.2% – it was still positive in a horror year. The human appetite for energy seems insatiable. Chinese consumption has doubled in 10 years to 1.9bn toe or 18% of global total. The US keeps top spot at over 20% but demand is stagnant. Chinese per capita consumption at less than 1.5toe remains under a quarter of the US' +6toe and less than half of much of the rest of the developed world. Australia per capita consumption at 4.5–6.0toe is relatively high, a function of the tyranny of distance and our heavy weighting to primary production.

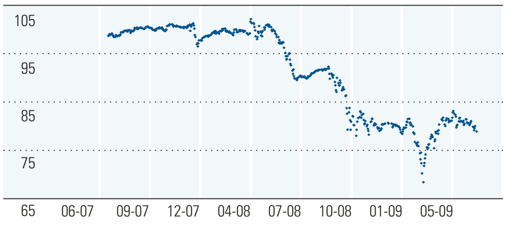
World Energy Consumption (Bn toe)



Source: BP

Renewable energy sources, excluding hydro, are growing rapidly helped by carbon incentives, but are still a negligible contributor to the mix overall, less than 1.5% of electricity generation. Oil retains the mantle of largest contributor at 3.9bn toe or 35%, but only just. Stagnant growth versus impressive volume gains from coal to 3.3bn toe, closely followed by natural gas 2.7bn toe, has oil on the proverbial ropes. Twenty five years ago oil accounted for over 40% of primary energy use. The trend in oil doesn't surprise. The reserves to production ratio around 40 is a third of coal's 120 and considerably less than 55 for gas. Energy consumers have diversified away from OPEC supplied oil to more reliable producers of other forms.

Reuters Energy Index (US$)



Source: Reuters

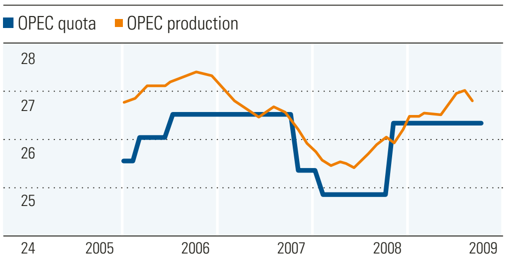
From mid 2008 levels just over 100, the Reuters' energy index fell over 30% to a mid March 2009 nadir of under 70. The global financial crisis and the hangover from record July 2008 oil prices around US$145/bbl was a large headache. The index has since partially recovered to around 80, with the world's most actively traded commodity launching off US$31/bbl lows plumbed in December to approach US$70/bbl now. Benchmark local oil counter **Woodside (WPL)** bounced 70% from late 2008 $27ps lows, but $40ps is still well below $70 peaks in May 2008. Oil futures predict a rising oil price, topping out at over US$90/bbl in 2017, above our long term US$80/bbl forecast.

Oil

The sharp pull-back in oil prices last year was a vivid reflection of demand destruction, particularly out of the US, due to high prices and economic turmoil. Global oil production increased only 0.4% to 81.8mmbopd in 2008. US consumption fell 6.4% to 19.4mmbopd. Chinese consumption grew 3.3% to 8mmbopd. The trend of growing consumption in producer countries including leader Saudi Arabia continues. The 11 countries under the OPEC banner increased production 2.7% to 36.7mmbopd but supply was tightened towards the end of the year.

From late 2008 OPEC cut targets in response to waning prices. A downtrend in production for several months was only broken in April this year when a rise of 270,000bopd was reported to 28.2mbopd, ahead of the group target level of 24.8mbodp. Iran was the main over-producer. Despite the recalcitrants, reduced supply has seen prices respond positively. The April jump in OPEC production lifts global oil supply to 83.6mmbopd.

OPEC Oil Quotas (millions barrels/day)



Source: netoilexports.blogspot.com

Our US$80/bbl long term oil price forecast is an approximate 20% premium to the 5-year US$67.35/bbl average. We expect a relatively rapid return to more normal +2% global growth in primary energy consumption. We still think the peak oil argument has legs and lethargic growth in traditional oil supply adds weight. Renewable

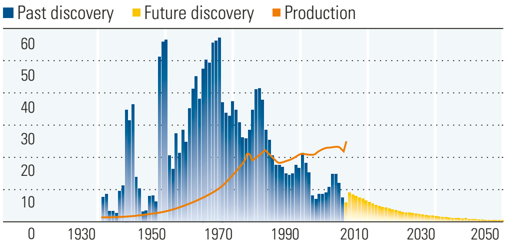
Oil Search OSH	
Price	$5.27
Recommendation	**Hold**
Accumulate Below ($)	4.90
Buy Below ($)	4.40
Last Review	26/02/09 (YMW08)
Business Risk	**High**
Price Risk	High
Moat Rating	None
Fair Value ($)	4.90

Santos STO	
Price	$14.01
Recommendation	**Buy**
Accumulate Below ($)	15.75
Buy Below ($)	14.20
Last Review	14/05/09 (YMW18)
Business Risk	**High**
Price Risk	High
Moat Rating	None
Fair Value ($)	15.75

Woodside Petroleum WPL	
Price	$41.36
Recommendation	**Buy**
Accumulate Below ($)	68.40
Buy Below ($)	61.55
Last Review	21/05/09 (YMW19)
Business Risk	**Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	68.40

energy will play a part but is likely to remain a fringe player for the foreseeable future. The implication for oil price is positive.

Discovery and Production of Conventional Oil

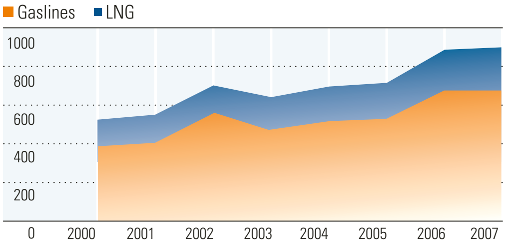


Source: ExxonMobil

Gas

We discussed trends in global gas markets last week and won't labour the issue. In summary natural gas comprises around one quarter of global primary energy supply and is the second fastest growing sector behind coal. Of the 2.7bn toe produced annually around a fifth is traded including 72% transported via pipelines and 28% in LNG tankers. Fortunately for Australia, the LNG component has been growing at a galloping cumulative annual average of 8%, the most buoyant Asian markets on our doorstep. There is potential for a near term supply glut with a swathe of new Australian LNG projects proposed. In the longer term even a modest market growth rate would comfortably account for proposed projects and probably drive a shortfall in supply.

World Gas Trade by Pipeline and LNG (2000–07)



Source: Global LNG Info

For now the market remains accommodating to new projects(/producers) with both **Santos (STO)** and **Oil Search (OSH)** in recent weeks reporting milestone LNG offtake agreements. Three major LNG buyers in the Asian region agreed to take PNG LNG product accounting for the full 6.3Mtpa capacity. The agreement still needs to be converted to "binding" status but is positive! OSH has an approximate 30% stake in the project. STO reported its 60% Gladstone LNG project signed a binding 2Mtpa sale to its partner PETRONAS with an option for a further 1Mtpa. That volume underpins the first LNG train.

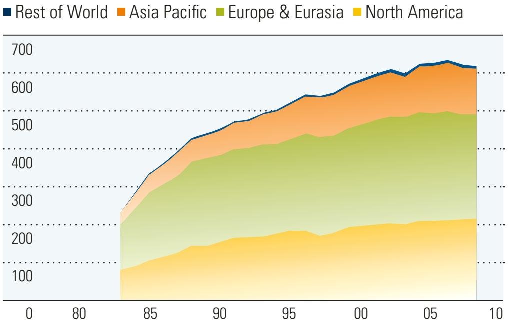
One thing we didn't discuss last week was price expectations. Our long term LNG price forecast is US$10.15/mmBtu, equivalent to a 20% discount to the energy equivalent oil price. The discount assumes gas will never quite reach the same utility as oil, perhaps an overly conservative stance given the potential for carbon constraints and increased pollution requirements to favour gas. That's not to assume that all companies will achieve precisely that price. WPL for example, the longest serving local LNG player, has legacy contracts, including some struck at particularly low prices with the Chinese, which will lower overall price achievement

With home gas markets, we assume A$7.55/PJ equivalent to 70% of the delivered (LNG) price with a further 15% domestic discount applied. We expect this price to be achieved by later next decade due to demand pull from east coast coal seam gas to LNG projects. Current pricing is less than half of this.

Uranium

Nuclear generation fell by 0.7% in 2008, the second consecutive fall. Japan down 10% was the primary cause, the aftermath of an earthquake, and the country around a tenth of the market. The US is the largest player at over 30% followed by France at 16%. Even without Japan the growth is sluggish and at odds with upbeat commentary. The truth is the nuclear industry has been in a holding pattern. There is tremendous growth underway and more planned, particularly out of China, but this hasn't hit yet.

Nuclear Power Generation by Region (Mtoe)



Source: BP

Regardless, premier Australian listed uranium exposure **Energy Resources (ERA)** reported record profits in 2008 and conditions in the uranium market are robust. Admittedly ERA's profit trend reflects roll-off of legacy contracts as much as production and the spot price. Regardless global mine supply remains constrained and secondary supplies are diminishing. Further there are over 100 new reactors under construction, on order or planned around the globe. China growth potential is enormous. Last year ERA was the first Australian company to sell uranium to China. New Chinese reactors with a combined 70GW capacity are being built by 2020. Our long term uranium price forecast is US$65/lb, a US$10 premium to the US$55/lb spot price, but a 20% discount to the five year average.

Fuel remains a relatively small component of the cost of producing nuclear energy. Uranium has very strong upside leverage to higher electricity prices. BHP's Olympic Dam accounts for 40% of global uranium resources and is a huge call option on any shift towards nuclear. As an established operating mine, Olympic Dam benefits from increasing resistance to new uranium mines – and coal mines too. RIO has exposure through Rossing and ERA. BHP's energy portfolio is on the whole better balanced. But RIO hydro, purchased via Alcan, could ultimately see the ugly duckling aluminium division bloom. M

Analysts: Mark Taylor, Mathew Hodge

Mining – Supercycle still in tact

BHP Billiton BHP	
Price	$33.73
Recommendation	**Buy**
Accumulate Below ($)	43.10
Buy Below ($)	38.80
Last Review	11/06/09 (YMW22)
Business Risk	**Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	43.10

Centennial Coal CEY	
Price	$2.40
Recommendation	**Hold**
Accumulate Below ($)	1.30
Buy Below ($)	0.95
Last Review	27/11/08 (YMW46)
Business Risk	**High**
Price Risk	High
Moat Rating	None
Fair Value ($)	1.85

Equinox Minerals EQN	
Price	$2.74
Recommendation	**Hold**
Accumulate Below ($)	1.75
Buy Below ($)	1.55
Last Review	16/04/09 (YMW14)
Business Risk	**Speculative**
Price Risk	High
Moat Rating	None
Fair Value ($)	1.95

The resource majors – **BHP Billiton (BHP)**, **Rio Tinto (RIO)**, Vale, Anglo American and Xstrata – are pretty much singing from the same hymn sheet. The downturn caused by the global financial crisis was unforeseen and essentially unprecedented. The expectation that China would "decouple" from the developed world, sustain demand for commodities and the miners would only see minor softening was only half right. China did partially decouple and continues to grow, but at a much reduced rate. India has little exposure to shrinking world trade and continues to expand strongly off a low base, underpinned by favourable demographics and heavy investment. The key to the collapse in commodities was the developed economies falling into an unbelievable hole. Unbelievable until it happened!

The scale of the collapse is astounding. Global steel production fell over 30% in seven months to December 2008. Europe, Japan and the US accounted for much of the decline. China's output remained relatively steady and its production rate recently turned positive compared to a year ago. India's output is up nearly 10% year on year. Asia, with the exception of Japan and Taiwan, is faring much better than Europe and the US. There are signs of life from the stragglers. Since bottoming in December 2008, global steel output has risen 17%, still 20% below the 2008 peak. The US is showing signs of bottoming, led by a very weak housing and a reduction in the rate of newly unemployed.

China accounts for nearly 50% of global steel output and the lion's share of growth. That's a positive for Australia. China is showing signs of behaving rationally in this downturn. High cost iron ore and coking coal mines have resulting in record imports, particularly benefiting Australia in 2009. The replacement of higher cost Chinese bulks with lower cost imports helped soften the blow for our miners. It also highlights the value of our low cost production. A few operations spring to mind. BHP and RIO's WA iron ore mines, BHP's Queensland coking coal operations, WA nickel sulphides, maybe Olympic Dam. Low cost operations are the last to feel the pinch in a downturn and the first to come out and look to grow again.

In the short term, commodity markets are expected to remain weak and volatile with the timing of recovery uncertain. There is cautious optimism for a rapid recovery but it's unclear if this will be V or W shaped. Chinese purchases above the underlying level of demand are not necessarily sustainable and don't equate to a recovery. Still there is universal optimism for the longer term despite consensus for an uncertain and weak outlook short term.

Long term demand for commodities is expected to continue to be driven by the urbanisation of China and India. The size of the trend and required growth to satisfy demand is large compared to current capacity. Supply side constraints will likely be exacerbated by the global financial crisis. Exploration and development expenditure are dramatically lower in 2009. Some of the l abour forced to exit the industry won't return. Legislative, environmental and social constraints are increasingly stringent. The approvals process is slow and infrastructure limits current output. Major projects have been cancelled or postponed. Funding, particularly debt, will be much harder to come by.

China can play an important role in filling the funding gap. Chinese funding to date has largely been restricted to Australian assets of tier three or worse ranking. Minmetals' purchase of most of Oz

Macarthur Coal MCC	
Price	$6.20
Recommendation	**Hold**
Accumulate Below ($)	4.20
Buy Below ($)	3.75
Last Review	04/06/09 (YMW21)
Business Risk	**High**
Price Risk	High
Moat Rating	None
Fair Value ($)	4.70

Mincor Resources MCR	
Price	$1.50
Recommendation	**Accumulate**
Accumulate Below ($)	1.55
Buy Below ($)	1.35
Last Review	14/05/09 (YMW18)
Business Risk	**High**
Price Risk	High
Moat Rating	None
Fair Value ($)	1.65

Newcrest Mining NCM	
Price	$29.47
Recommendation	**Hold**
Accumulate Below ($)	25.00
Buy Below ($)	22.50
Last Review	30/04/09 (YMW16)
Business Risk	**Medium**
Price Risk	High
Moat Rating	None
Fair Value ($)	25.00

New Hope NHC	
Price	$4.39
Recommendation	**Hold**
Accumulate Below ($)	4.25
Buy Below ($)	3.75
Last Review	28/05/09 (YMW20)
Business Risk	**Medium-High**
Price Risk	Medium
Moat Rating	None
Fair Value ($)	4.75

Minerals' assets is a notable exception. Contrary to conventional market wisdom, we expect the Chinese will ultimately learn they can get a better bang for their buck investing in better quality projects. A host of wannabe miners priced as though Chinese largesse was a foregone conclusion might disappoint.

Teaming up with the majors with equity stakes in individual projects is the way to go. Chinalco's failed funding tilt at RIO shows the Chinese are catching on, yet that structure was not right. The Japanese trailblazed in the 80s and gained a host of minority stakes in the best legacy assets as a result – WA iron ore, Queensland coking coal, Escondida, the list goes on. Those minority stakes facilitated development and meaningful increases in low cost supply from reliable, quality miners.

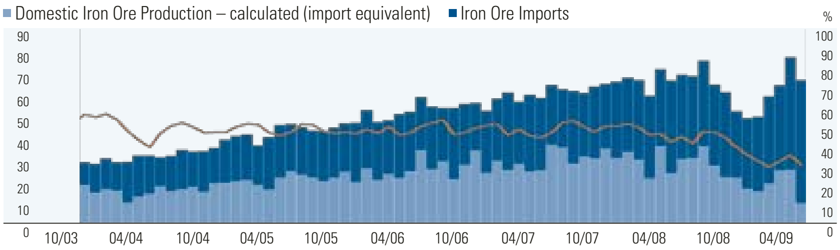
Price Falls

	Peak	Date	Trough	Date	Fall (%)
A$/US$ FX	0.985	15/07/08	0.600	02/11/08	-39.1
Aluminium (US$/lb)	1.48	11/07/08	0.57	01/03/09	-61.6
Copper (US$/lb)	4.08	03/07/08	1.27	28/12/08	-68.9
Gold (US$/oz)	1030.8	17/03/08	680.8	26/10/08	-34.0
Iron Ore (US$/t)*	108.0	15/07/08	55.0	01/11/08	-49.1
Lead (US$/lb)	1.81	10/10/07	0.38	21/12/08	-78.8
Nickel (US$/lb)	24.58	15/05/07	4.05	07/12/08	-83.5
Oil (US$/bbl)	145.66	11/07/08	30.81	28/12/08	-78.8
Silver (US$/oz)	21.24	14/03/08	8.42	02/11/08	-60.4
Zinc (US$/lb)	2.09	24/11/06	0.49	14/12/08	-76.5

* Spot price landed in China

The severity of the falls in commodity prices is striking. Most fell more than 50% in about six months. Some like nickel, zinc, lead and oil were hit even harder. The recovery has been amazing too. From the troughs of late 2008, prices have marched ahead strongly. The recovery has arguably been a bit too fast for copper, the price moving well ahead of fundamentally weak demand. The iron ore price looks to have a bit more underpinning. The rapid reduction in Chinese domestic iron ore production is unexpected and strongly positive for RIO and BHP in particular. Zinc and aluminium demand remain under pressure with prices relative to the cost curve stressing some producers.

China Iron Ore Requirements (Mt)



Source: Rio Tinto

Recovery

	Trough	Spot 24/6/09	Gain (%)
A$/US$ FX	0.600	0.794	+32.3
Aluminium (US$/lb)	0.57	0.71	+24.4
Copper (US$/lb)	1.27	2.18	+71.8
Gold (US$/oz)	680.8	924.8	+35.8
Iron Ore (US$/t)	55.0	65.0	+18.2
Lead (US$/lb)	0.38	0.76	+98.0
Nickel (US$/lb)	4.05	6.67	+64.6
Oil (US$/bbl)	30.81	66.93	+117.2
Silver (US$/oz)	8.42	13.87	+64.7
Zinc (US$/lb)	0.49	0.68	+39.4

Iron ore is now one of the markets that appeals most. Preferred exposure is BHP and at current prices RIO. Iron ore is nearly twice as important to RIO compared to BHP and generates over half its earnings. RIO has been more harshly dealt with by the correction. Its rights issue at US$15.2bn, US$3.4bn of which will be raised here and the remainder in the UK is by far the largest of the recent capital raisings our market has seen. The timing is somewhat unfortunate – fortunate if you want to buy RIO – with the market getting a touch of the wobbles. A correction is no shock given the vigour of the preceding rally. The quality of RIO's operations was never in doubt, only its balance sheet. The rights issue coupled with improved commodity prices means the market can again focus on asset quality.

Beyond the headlines of a 37% decline in the contract iron ore price from April 2009, a number of positives emerge from the credit crisis. A collapse in China's domestic production of iron ore was a pleasant surprise. China could have chosen to protect its high cost producers. Instead Australia and Brazil gain. Australia is shipping record volumes of iron ore thanks to our largest customer, China. The cost advantage BHP and RIO enjoy over most producers should equate to sustainably favourable margins. The majors have weathered the credit crisis relatively unscathed and long term positions are improved.

There are parallels in coal. For the first time, China is moving – perhaps opportunistically – to become a meaningful importer of coal, in particular coking coal. Until recently this year, China was all but self sufficient and only a minor participant in the traded market. Chinese stepping up as other customers defaulted so helped save pain for a few miners. China is a coal gorilla, consuming 2.8Bt a year, more than twice its nearest rival the US and over

OZ Minerals OZL	
Price	$0.90
Recommendation	**Hold**
Accumulate Below ($)	0.80
Buy Below ($)	0.70
Last Review	11/06/09 (YMW22)
Business Risk	**High**
Price Risk	High
Moat Rating	None
Fair Value ($)	0.80

Panoramic Resources PAN	
Price	$2.52
Recommendation	**Hold**
Accumulate Below ($)	2.15
Buy Below ($)	1.70
Last Review	11/06/09 (YMW22)
Business Risk	**High**
Price Risk	High
Moat Rating	None
Fair Value ($)	2.35

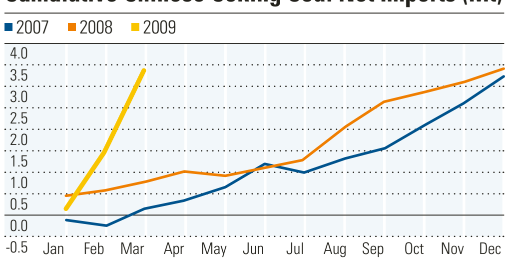
Rio Tinto RIO	
Price	$49.60
Recommendation	**Buy**
Accumulate Below ($)	83.20
Buy Below ($)	74.85
Last Review	11/06/09 (YMW22)
Business Risk	**Medium**
Price Risk	Medium
Moat Rating	Narrow
Fair Value ($)	83.20

Western Areas WSA	
Price	$5.19
Recommendation	**Hold**
Accumulate Below ($)	4.55
Buy Below ($)	3.80
Last Review	23/04/09 (YMW15)
Business Risk	**Speculative**
Price Risk	High
Moat Rating	None
Fair Value ($)	4.90

40% of the global total. There is potential for a similar import substitution story to play out in coal as has occurred in iron ore. There is an argument that cleaner Australian coal could displace dirty Chinese coal but not one we put a lot of stock in at this stage.

Our preference in the coal space is for **New Hope (NHC)** thanks to its conservative balance sheet, low cost operations and port ownership. **Centennial Coal (CEY)** has long term appeal as lower priced domestic contracts roll off and more coal becomes available for the higher priced export market. It's been difficult to time investment in CEY with short term twists and turns dominating the share price. The stock is up for review and key will be pricing for potential long term rewards versus risk. **Macarthur Coal (MCC)** is mid to high cost and needs to pull back from impressive gains for our interest to be rekindled. BHP offers some exposure to world class coking coal assets in a diversified portfolio.

Cumulative Chinese Coking Coal Net Imports (Mt)



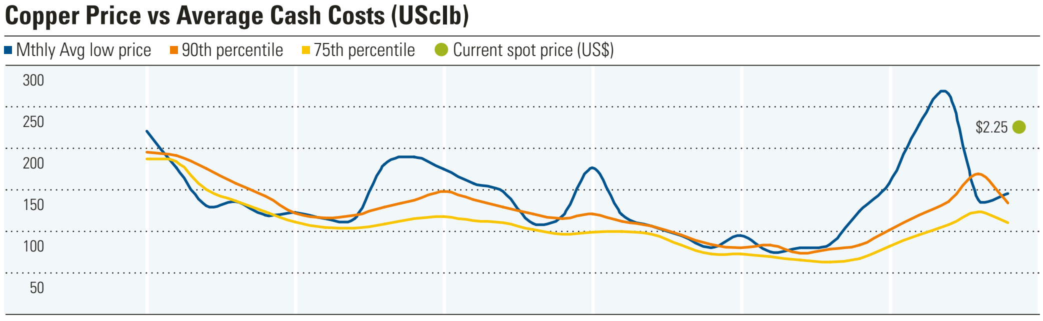
Source: Centennial Coal

Of the base metals, copper's rally looks the most speculative and overdone in the short term. As the chart shows, margins at +US$2.00/lb are historically favourable. China is widely acknowledged as buying more than it currently needs. Some speculators have followed that trade. The copper price is excellent in historical terms and well above a rapidly declining cost curve. Virtually all copper miners are making good money in the current environment and there is little pressure to consolidate or reduce capacity. Longer term the outlook is bright. Copper is a key metal developing countries. A correction would provide a nice opportunity to get sensibly priced exposure to that growth. Of the copper companies, we prefer **OZ Minerals (OZL)** over **Equinox (EQN)** primarily due to balance sheet and sovereign risk. OZL is Australian based and swimming in cash while EQN bares debt and African risk. EQN will regain speculative appeal if this correction gains momentum. BHP and RIO offer copper exposure as part of a diversified portfolio while for **Newcrest (NCM)**, copper is a secondary product behind gold and one the stock typically doesn't get much credit for.

Nickel equities moved up with the metal's price and are no longer out-and-out steals. Stainless steel is an important construction material for BRIC economies. As iron ore has thrown the focus on low cost Australian producers, nickel's correction highlighted established nickel sulphide production over laterites. BHP's Ravensthorpe and Minara's (MRE) Murrin Murrin mines have proven technically challenging, overly capital intensive and unreliable. Nickel production growth was largely expected to come from laterites but the correction has highlighted the weak competitive position these mines face. Sulphide producers stand to benefit from higher prices and growth with little additional capital investment. A correction could provide a good opportunity to buy the small players like Independence Group (IGO), **Mincor Resources (MCR)**, **Panoramic Resources (PAN)** and **Western Areas (WSA)**. Higher risk dictates only small slices are appropriate. **M**

Analysts: Mathew Hodge, Mark Taylor

Copper Price vs Average Cash Costs (USclb)



Source: BHP Billiton