Macquarie Private Wealth
Listed Research

Equity Strategy

RIO and BHP are standouts

Event

- We have increased the overweight positions to both **RIO** and **BHP** in the recommended portfolio.

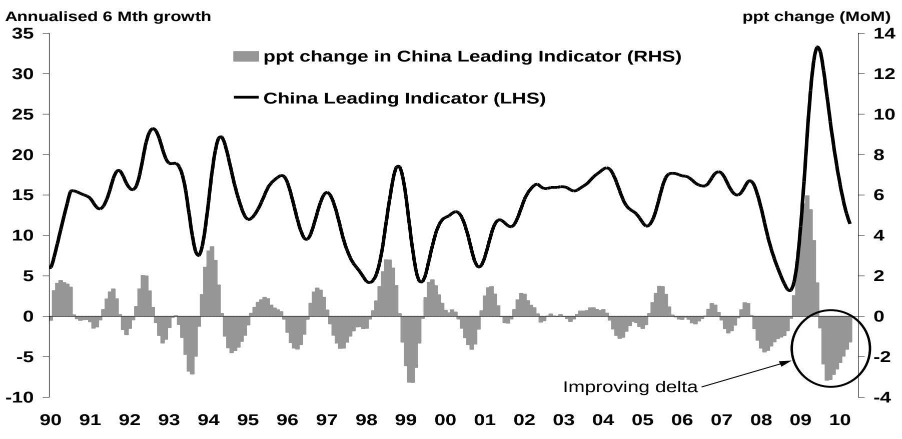
Impact

- The strong US manufacturing recovery remains on track. China has slowed but appears likely that the authorities will soon moderate their restrictive policies (the floating of the Renminbi helps also). Europe is now at least trying to deal with its problems. All of this suggests that the macro environment for commodity prices is once again moving to the positive. **RIO** in particular, but also **BHP**, are both trading near their lowest valuations seen over the past two decades at a time when their earnings growth outlooks remain very strong.

Outlook

- The world remains a very mixed picture; however the outlook does appear to be tilting decisively towards the positive over the next year. Most importantly the largest manufacturing recovery seen in the US for over 35 years remains firmly on track. This is in turn delivering very strong US corporate earnings growth (35.2% in CY10 and 17.6% in CY11). We expect US investors to increasingly focus on their own strong domestic outlook and turn their attention away from the problems in Europe. The latter is struggling but will likely slide from the headlines as the strong monetary stimulus now in place buys the region time to rationalise its unwieldy banking system.
- China is slowing from the extreme growth rates of early this year. However events there are moving quickly. The coastal property markets have already slowed dramatically, especially in transaction volume terms. Recent manufacturing and inflation numbers have also softened. We expect that over the next few months, Chinese authorities will slowly soften their language on property and other economic restrictions imposed earlier this year with a view to ensuring a "soft" landing of about 8% real GDP growth.
- The OECD leading indicator for China has already begun to slow its rate of decline in the last few months…

Critical Chinese leading indicator is beginning to turn



Source: OECD, Datastream, Macquarie Research, June 2010

AUSTRALIA

Market and sector EPS growth (%)

Pro-rated to June	FY09A	FY10E	FY11E	Current 1 yr fwd
All Companies	-16.4	2.2	31.1	30.4
Banks	-20.3	14.0	15.9	15.8
Property Trusts	-20.7	-29.3	0.0	-0.7
Resources	-19.9	5.6	65.8	64.4
Industrials (All Cos ex Res, LPTs, Banks)	-8.9	-1.2	17.5	17.0

Source: Macquarie Research, June 2010

Market and sector PEs (x)

Pro-rated to June	FY09A	FY10E	FY11E	Current 1 yr fwd
All Companies	15.5	15.1	11.6	11.6
Banks	14.7	12.8	11.1	11.1
Property Trusts	9.4	13.3	13.3	13.3
Resources	18.2	17.2	10.5	10.6
Industrials (All Cos ex Res, LPTs, Banks)	14.7	14.9	12.8	12.8

Source: Macquarie Research, June 2010

Market and sector DPS growth (%)

Pro-rated to June	FY09A	FY10E	FY11E	Current 1 yr fwd
All Companies	-17.7	-1.9	9.9	9.6
Banks	-20.3	9.2	17.2	17.0
Property Trusts	-31.4	-28.7	-7.8	-8.3
Resources	12.5	-7.7	8.6	8.2
Industrials (All cos ex Res, LPTs, Banks)	-20.9	-0.9	9.7	9.4

Source: Macquarie Research, June 2010

Market and sector Dividend Yield (%)

Pro-rated to June	FY09A	FY10E	FY11E	Current 1 yr fwd
All Companies	4.0	3.9	4.3	4.3
Banks	5.0	5.5	6.4	6.4
Property Trusts	8.6	6.1	5.6	5.6
Resources	2.2	2.0	2.2	2.2
Industrials (All cos ex Res, LPTs, Banks)	4.9	4.9	5.3	5.3

Source: Macquarie Research, June 2010

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Fig 1 Macquarie Equity Strategy – Recommended Portfolio

Company	Code	Share price 21 Jun 10	Portfolio Weight (%)	Index Weight (%)	Active Weight (%)
WorleyParsons	WOR	$22.54	2.1	0.5	1.6
Origin Energy	ORG	$15.95	3.4	1.4	2.0
Woodside Petroleum	WPL	$45.65	3.5	2.3	1.2
Energy			**9.0**	**7.0**	**1.9**
BHP Billiton	BHP	$39.91	16.3	13.2	3.1
Rio Tinto	RIO	$72.34	6.6	3.1	3.6
Mining			**22.9**	**20.6**	**2.3**
News Corporation	NWS	$18.29	4.3	0.8	3.6
James Hardie	JHX	$6.74	1.7	0.3	1.4
Seek	SEK	$7.81	1.9	0.3	1.7
Cyclicals			**7.9**	**10.7**	**-2.8**
Commonwealth Bank	CBA	$53.28	11.2	8.2	3.0
Westpac Bank	WBC	$23.84	6.7	7.0	-0.3
National Australia Bank	NAB	$25.39	8.5	5.3	3.2
Banks			**26.4**	**27.0**	**-0.6**
QBE Insurance	QBE	$18.96	3.5	1.9	1.5
Insurance and div financials			**3.5**	**7.9**	**-4.4**
Woolworths	WOW	$27.81	6.5	3.5	3.0
Wesfarmers	WES	$29.70	5.9	3.4	2.6
CSL	CSL	$33.97	3.6	2.0	1.6
Growth			**16.0**	**12.1**	**3.9**
CFS Retail Property	CFX	$2.00	2.1	0.4	1.7
Westfield	WDC	$12.77	5.9	2.7	3.1
Property Trusts			**7.9**	**6.4**	**1.5**
AGL Energy	AGK	$14.82	3.0	0.7	2.4
Coca Cola Amatil	CCL	$11.83	3.4	0.6	2.8
Defensives			**6.4**	**8.3**	**-1.9**
TOTAL			**100.0**	**100.0**	

Note: ASX100 index weights and active index weights

Performance ending 31-May-10

	1 Month (%)	6 Months (%)	1 Year (%p.a.)	2 Years (%p.a.)	3 Years (%p.a.)	5 Years (%p.a.)	Since Inception (%p.a.)
Portfolio	-7.9	-4.8	18.5	-1.9	-1.1	10.8	10.2
ASX100 Accum	-7.5	-4.1	20.9	-6.6	-6.5	6.2	6.0
Relative	**-0.5**	**-0.7**	**-2.4**	**4.7**	**5.4**	**4.5**	**4.2**
Tracking error			1.8	4.7	4.4	3.7	3.7
Information Ratio			-1.3	1.0	1.2	1.2	1.1

Portfolio Changes

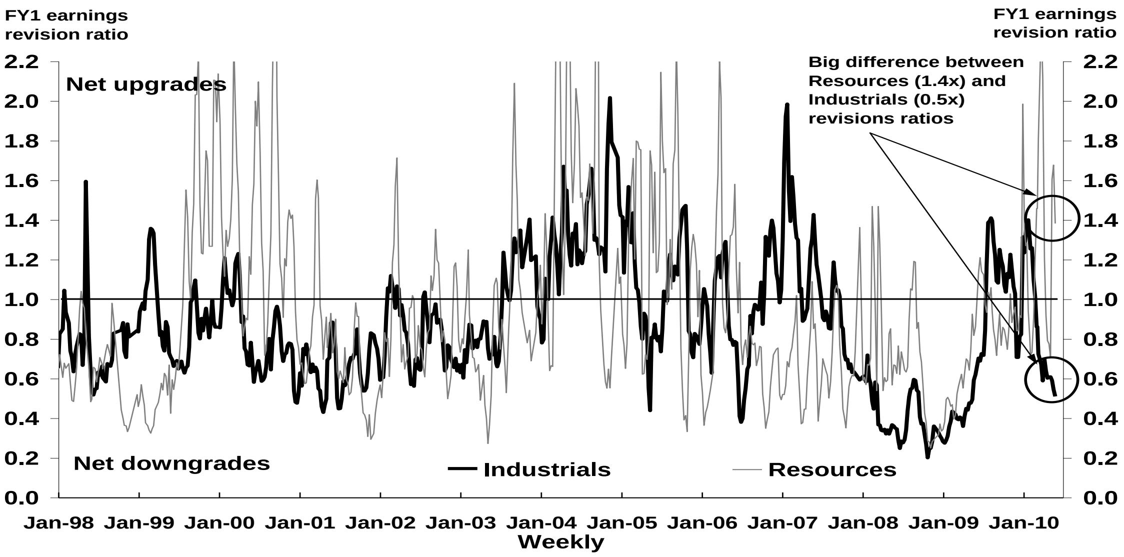
Stocks Added		**Stocks Removed**	
		SHL	1.5
		PTM	0.9
Increased Weight		**Reduced Weight**	
RIO	1.9	WBC	1.0
BHP	1.5		
Total	**3.4**		**3.4**

Note: Index weights above are as at Friday 18 June while portfolio weights are updated to 21 June

Source: IRESS, Macquarie Research, June 2010

- The month-on-month ppt change in the China leading indicator (6 month annualised growth rate) is now just -1.3ppts compared to the peak monthly fall of -3.2ppts early this year (see chart on front page). Another three months and this indicator will likely be moving sideways, that is the currently negative delta is now swinging towards the positive.
- By the December quarter 2010 the northern Pacific region should be firmly back on the economic front foot. Commodity prices have been resilient thus far this year, so any improvement of the economic rate of change should have a meaningfully positive effect.
- There is currently a large divergence in the direction of earnings revisions with Australia. The resources sector has recently seen a strong earnings rebound as the revisions ratio now stands at a buoyant 1.4x. By contrast the Industrials sector has continued to slide towards a revisions ratio of 0.5x under the pressure of higher local interest rates which have slowed the housing, consumer and business investment sectors. This rapid and recent divergence should result in investment flows targeting resources at the expense of industrials over the next few months.

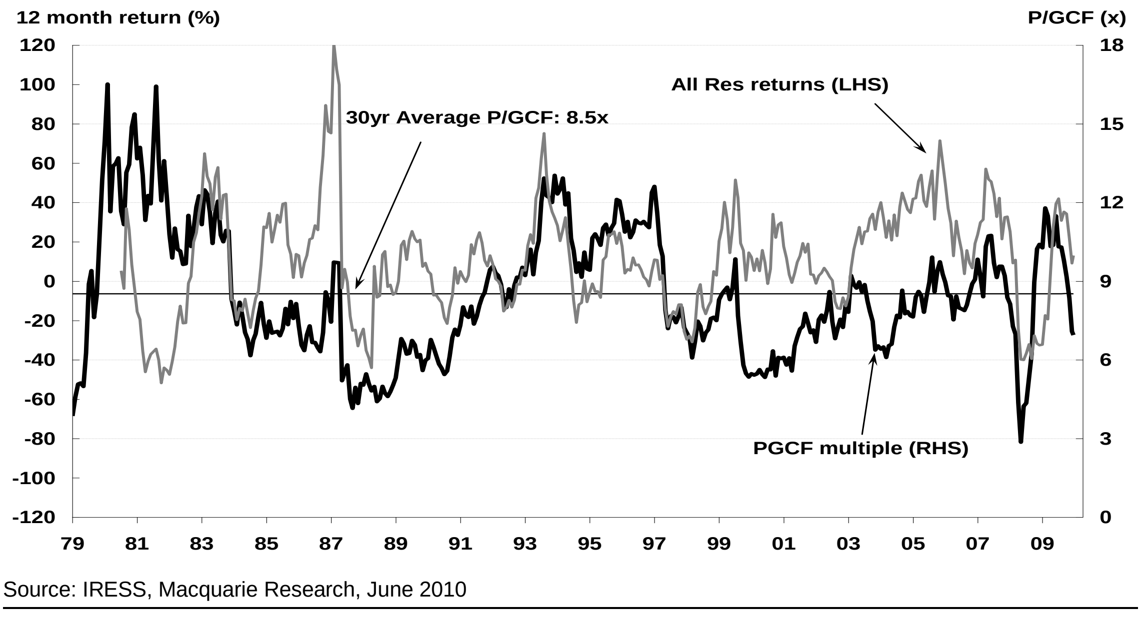
Fig 2 Strong Resources sector revisions ratio highlights widening gap between Industrials and Resources earnings performance



Source: IBES, Macquarie Research, June 2010

- The valuation of the mining sector remains very low with the Price/Gross Cash Flow multiple for the sector now just below 7x, the lowest since the GFC and more importantly in the bottom quartile of valuations seen over the past thirty years and some 19% below the long-term average.

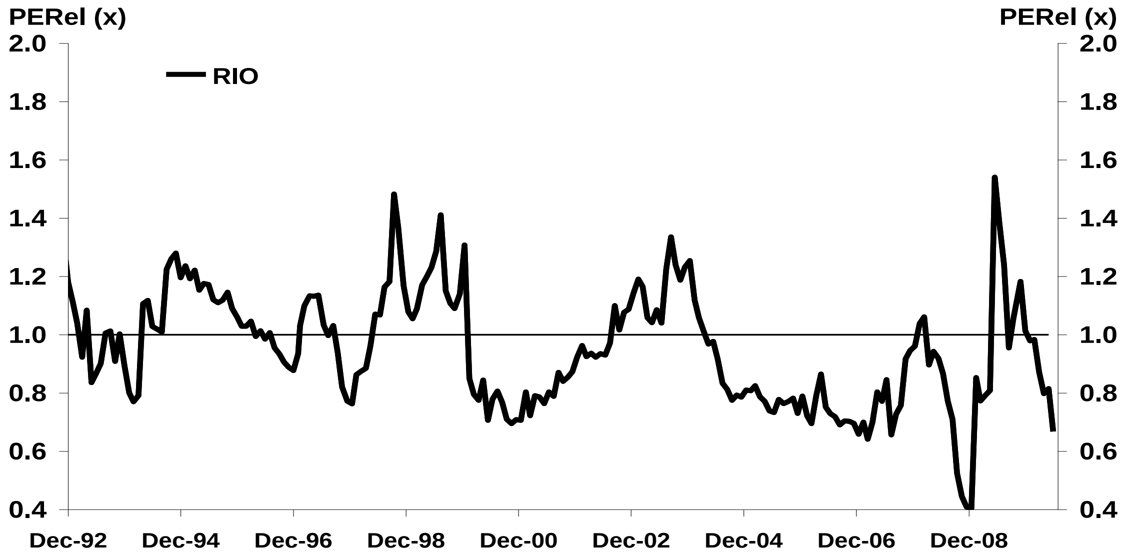
Fig 3 Major miners P/GCF is also in cheap territory – currently below 7x



Source: IRESS, Macquarie Research, June 2010

- **RIO** remains the standout cheap stock in the Australian market as the relative PER valuation stands at a 34% discount to a market PER, which is also undervalued. For only a few months in the depths of the GFC was RIO more heavily discounted, while balance sheet risk is no longer a contributing factor following the equity raising of last year. The relative PER has continued to fall in recent weeks due to earnings upgrades following increases in iron ore forecasts.

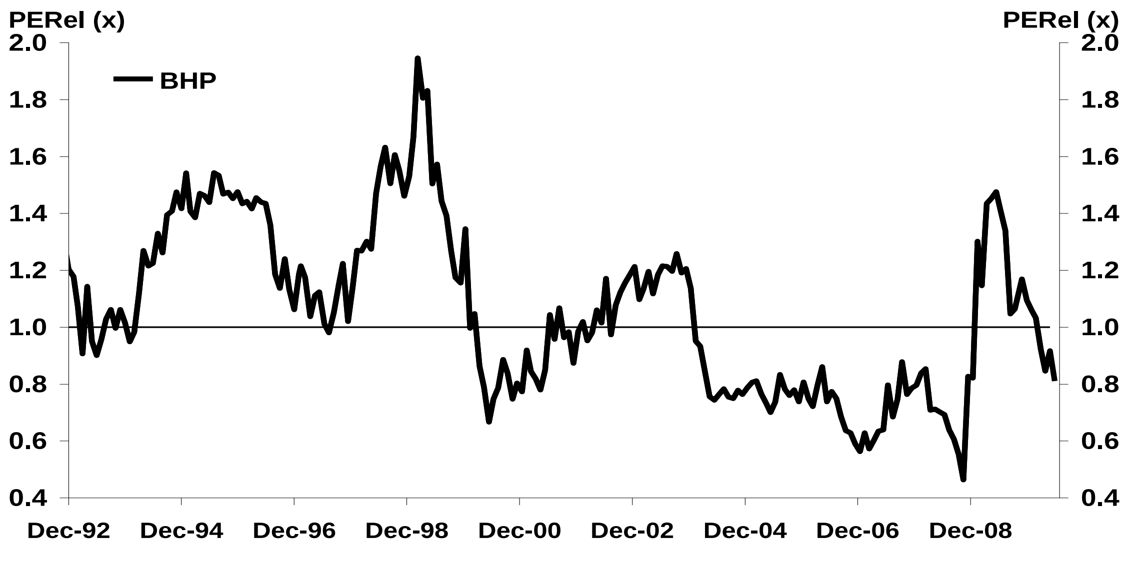
Fig 4 RIO relative PER (0.66x) at an extremely low level



Source: Macquarie Research, June 2010

- The valuation case for **BHP** is not as strong, nevertheless the relative PER is comfortably below the long term average. Importantly for both stocks the strong earnings upgrade trend is delivering one year forward EPSg forecasts of 52% for BHP and 83% for RIO. Both forecasts are several multiples of the one year forward All Industrials EPSg forecast, which stands at just 15%.

Fig 5 BHP relative PER (0.8x) at a low level



Source: Macquarie Research, June 2010

- To fund the increased positions in **RIO and BHP** we have dropped the defensive **SHL** from the portfolio. Government pricing regulation and the related uncertainties are likely to continue to weigh on the stock. We have also further reduced the overall banking position to a small underweight via a reduction in the **WBC** exposure. This reflects the better international prospects of resources compared with the slowing domestic scene in Australia. In our view, it appears likely that the banks will suffer some incremental earnings downgrades given weak consumer and business lending growth rates. The small position in **PTM** has also been removed, itself a global cyclical, as **RIO and BHP** are trading on more compelling current valuations.

Important disclosures:

Recommendation definitions

Macquarie - Australia/New Zealand
Outperform – return >5% in excess of benchmark return
Neutral – return within 5% of benchmark return
Underperform – return >5% below benchmark return

Macquarie – Asia/Europe
Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie First South - South Africa
Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie - Canada
Outperform – return >5% in excess of benchmark return
Neutral – return within 5% of benchmark return
Underperform – return >5% below benchmark return

Macquarie - USA
Outperform (Buy) – return >5% in excess of Russell 3000 index return
Neutral (Hold) – return within 5% of Russell 3000 index return
Underperform (Sell)– return >5% below Russell 3000 index return

Recommendations – 12 months

Note: Quant recommendations may differ from Fundamental Analyst recommendations

Volatility index definition*

This is calculated from the volatility of historical price movements.

Very high–highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low–medium – stock should be expected to move up or down at least 25–30% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.
* Applicable to Australian/NZ/Canada stocks only

Financial definitions

All "Adjusted" data items have had the following adjustments made:
Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit / efpowa*
ROA = adjusted ebit / average total assets
ROA Banks/Insurance = adjusted net profit /average total assets
ROE = adjusted net profit / average shareholders funds
Gross cashflow = adjusted net profit + depreciation
*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

Recommendation proportions – For quarter ending 31 March 2010

	AU/NZ	Asia	RSA	USA	CA	EUR	
Outperform	50.55%	62.20%	42.25%	42.39%	62.16%	46.74%	(for US coverage by MCUSA, 6.53% of stocks covered are investment banking clients)
Neutral	36.63%	19.02%	47.89%	50.35%	31.89%	34.78%	(for US coverage by MCUSA, 9.62% of stocks covered are investment banking clients)
Underperform	12.82%	18.78%	9.86%	7.27%	5.95%	18.48%	(for US coverage by MCUSA, 0.00% of stocks covered are investment banking clients)

Company Specific Disclosures:
The Macquarie Group is acting for Rio Tinto in relation to its proposed Western Australian Iron Ore Production Joint Venture with BHP Billiton as announced on 5 June 2009. The Macquarie Group acted as Joint Global Coordinator in relation to the Rights Issues by Rio Tinto PLC and Rio Tinto Limited as announced 5 June 2009. The Macquarie Group acted as Advisor to Rio Tinto Ltd. and Rio Tinto PLC in relation to its partnership with Chinalco as announced 12 February 2009. Within the last 12 months, Macquarie Group has received compensation for investment advisory services from Rio Tinto Limited. The analyst and/or associated parties own or have other interests in securities issued by RIO. The Macquarie Group is acting for Rio Tinto in relation to its proposed Western Australian Iron Ore Production Joint Venture with BHP Billiton as announced on 5 June 2009. The analyst and/or associated parties own or have other interests in securities issued by BHP. Within the last 12 months, Macquarie Group has received compensation for investment advisory services from BHP Billiton Limited.
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