Factor X

2016 has had its fair share of shocks with Brexit and the election of Donald Trump as US President, but don’t forget the rally in resources stocks. In today’s note, Tony Featherstone calls the sector this year’s Factor X. Is it time for some profit taking?

Sincerely,

Peter Switzer

Inside this Issue

02 Resources sector – 2016’s Factor X?
Profit-taking
by Tony Featherstone

05 The TRIS trap – don’t get caught
What you need to know
by Graeme Colley

07 Bonds get trumped
Volatility and opportunity
by Charlie Aitken

09 Buy, Sell, Hold – what the brokers say
Upgrades and downgrades
by Staff Reporter

13 Questions of the week – dividend-payers and Telstra
Reader queries
by Questions of the Week
There is a long list of contenders for 2016’s Factor X – the big market-moving event that surprised investors. They include Brexit, Donald Trump’s ascension to United States President-elect and the remarkable rally in resource shares.

For mine, the resource sector stole the show and is a clear winner for Factor X. Brexit and the US election were, for the most part, close-run affairs. Even diehard contrarians would not have seen 70% gains in BHP Billiton and other key miners from this year’s lows.

But it is time to take some profits in resource shares after a rally that appears to be driven more by investor sentiment and fund flows than commodity and economic fundamentals. A rally that has questionable foundations.

That does not mean dumping resource shares or making rash decisions. Identifying an interesting stock to buy is one thing; suggesting investors sell an overvalued stock is a different beast, for so much depends on the entry price, overall portfolio and investor goals, and tax position.

Those who snapped up BHP Billiton at its 52-week low of $14.06 in January, or Rio Tinto at $36.53 earlier this year, are sitting on paper gains of 70% and 60% respectively in less than a year. Those who bought Fortescue Metal Group at its $1.44 low are up 322%.

Coking-coal prices have rallied from under US$80 a tonne a year ago to US$308 a tonne this week. Supply interruptions and production cutbacks, and a pro-coal US President-elect in Trump, are boosting a sector that many investors gave up on last year.

This is the stuff of a rampant bull market, not one that faces the headwinds of lacklustre global economic growth and persistently high volatility and uncertainty. After falling too hard, resource stocks have rallied too far, too fast. Some profit-taking is required.

Consider recent gains in commodity prices. Spot iron-ore prices (with 62% content) have doubled from this year’s lows in January to US$79.81 a tonne. They jumped about 20% this month alone. Few saw that coming.

Copper, a bellwether for global economic activity, has jumped from US$2.10 a pound in late October to US$2.47. After lagging other metals for much of 2017, copper roared to life this month after Trump’s election victory.

Chart 1: Copper

Coking-coal prices have rallied from under US$80 a tonne a year ago to US$308 a tonne this week. Supply interruptions and production cutbacks, and a pro-coal US President-elect in Trump, are boosting a sector that many investors gave up on last year.

Trump’s election win was like gasoline to a simmering resource rally. After initially buying gold, investors decided Trump was good news for US economic growth and the world economy, thanks to his lower-taxes and infrastructure-spending mantra.

Markets appear convinced Trump will moderate at least some of his controversial election promises and
have a more conciliatory style as President than he did while campaigning. That potential is stronger US growth without the damaging consequences of a potential trade war with China and other isolationist policies he promoted.

Risk on, or risk off?

A clear divide is growing: there are those who are buying “risk”, believing Trump’s policies will stimulate the US economy and commodities markets in particular. They are buying resource stocks, companies exposed to infrastructure spending and growth cyclicals.

Others believe Trump will add to global economic risk and uncertainty. The details of several of his key policies are sketchy – it’s a guessing game as to whether he will tone down his election promises, or how other countries will react. These investors are buying gold (which has sold off too far since the US election) and increasing portfolio cash weightings.

I believe Trump will be good for US economic growth, though not by nearly as much as markets are pricing in. His infrastructure plan, encouraging as it is, lacks detail. And large infrastructure projects typically have long lead times and much debate. Oh, and there’s the small matter of how the US Government will fund substantial new infrastructure investments, even though Trump says the plan will be deficit-neutral.

Then there’s China. Trump’s policy position was to label China a “currency manipulator” and bring trade cases against it. Should he follow through on his rhetoric, which included hefty tariffs on Chinese imports, China’s economy could be badly damaged. That is the last thing commodity markets need given the importance of Chinese minerals demand.

US politics aside, latest economic data from China suggests its economy is not picking up as strongly as expected. Most countries would kill for annualised economic growth of 6.1% in October, but markets wanted a little more. China’s economic gains this year are solid rather than spectacular, by its standards; certainly not enough to warrant soaring commodity prices on the demand front.

Commodities, too, give clues about the sustainability of recent price gains. Short covering and momentum trading, where algorithmic trading programs chase uptrending asset prices, are arguably the main drivers of recent gains in iron-ore prices.

Moreover, stronger-than-expected Chinese steel demand has supported price gains this year, but a likely moderation in steel output over the next six months will weigh on the iron-ore rally. Iron-ore supply is plentiful and higher prices will encourage greater supply.

Macquarie Equities Research this week wrote: “Iron-ore market fundamentals remain unchanged, and we continue to believe prices have clearly overshot on this recent speculative rally and should soon ease back to trade in a fundamentally supported $US45-55 a tonne range before long.”

Production: analyst reaction is telling

Perhaps the best indicator of the commodity rally’s sustainability is producers themselves. Several marginal, higher-cost producers that exited markets, such as coal, have not brought production back on line as bulk metal prices have risen. That suggests they doubt the commodity-price strength will last.

Let’s not forget that global economic growth remains moderate – 3.1% on International Monetary Fund forecasts, if one can believe them. Economic, trade and sovereign risks are rising, so it’s hard to see a big uplift in commodity demand. Nor can one see a large enough drop in commodity supply to justify this year’s incredible price rally.

Finally, consider mining company valuations. At $24.55, BHP Billiton is trading about a third higher than the mean price target of $18.19, based on the consensus of 23 analysts who cover the stock. Either the market is hopelessly wrong on BHP, or Australia’s largest mining company has rallied too far, swept up in the latest commodity euphoria.

Charts: BHP Billiton

Thursday 17 November 2016
Rio Tinto, at $58.95, trades 36% higher than the mean price target of $43.39, based on a consensus of 18 analysts. Fortescue is trading 80% above its consensus price target of $3.36 and Woodside is 23% above its mean consensus price target.

Consensus analyst forecasts, hardly infallible, are already factored into share prices: the best gains come from identifying when the consensus is badly wrong, as has been the case with BHP, Rio and Fortescue this year. But even the most bullish broking forecasts on these stocks, outliers from the consensus, are struggling to keep up with recent prices gains. Some broking firms, starting to lift their commodity price forecasts, will increase mining company valuations. But analysts, sensibly, are questioning the sustainability of recent gains in mineral prices in their valuations and have commodity forecasts well below metal spot prices.

This analysis is not meant to disparage the prospects of BHP, Rio or Fortescue. Rather, it’s a reminder that every stock has its price. Nor does it imply the resource rally will fall in a heap anytime soon; as more fund managers rotate out of interest-rate-sensitive stocks (as bond yields rise) money could find its way to the resources sector. There is plenty of short-term momentum behind the resource trade. Still, the big miners are trading above their intrinsic or fair value, boosted by investor sentiment that Trump will send the US economic growth engine up another gear. I’m not as optimistic.

There’s a case to reduce exposure to resource stocks and increase cash holdings in portfolios, in anticipation of better value in the next 3-6 months. Global equity market valuations, particularly in the US, are stretched. A potential bear market in bond prices, and rising bond yields, is a growing concern for sharemarkets worldwide, for it affects equity valuations.

A large overweight position in resource stocks, a dream ride in 2016, will be a significant portfolio threat if Trump disappoints and markets inevitably reassess the global economic outlook and the fundamentals supporting this commodity-price surge.

This year’s Factor X in resource shares could be next year’s Factor Why?

Tony Featherstone is a former managing editor of BRW, Shares and Personal Investor magazines. All prices and analysis at November 15, 2016.

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Anyone who has a transition to retirement income stream (TRIS) should be aware of a number of implications if the proposals announced in this year’s Federal Budget take place from 1 July 2017. Stopping work after 1 July 2017 or starting a short-term job which ends after age 60 are just a few things that could catch anyone out unexpectedly.

Under the current rules, any income earned on investments made by the superannuation fund and used to start a TRIS is tax free. For anyone between preservation age (currently 56) and 60, the taxable amount of pension payments received by the fund member is taxed at personal rates and receives a 15% tax offset. For anyone who is at least 60, the pension payments are tax free when received from the fund.

From 1 July 2017, the rules will change so that any income earned by the superannuation fund on investments used to support the payment of the TRIS will be subject to tax at the fund’s standard 15% tax rate. A TRIS will be treated as being in accumulation phase from that time rather than retirement phase as it is under the current rules. There will be no change to the taxation of the TRIS when received by the member.

Another change is the proposed introduction of the $1.6 million transfer balance cap. The cap applies to amounts transferred to retirement phase and used to start an income stream. This applies to account based income streams and other pensions such as lifetime and life expectancy complying pensions. It does not apply to amounts used to start a TRIS as they form part of the amounts in accumulation phase. Once the pension cap has been exceeded the excess is required to be transferred back to accumulation phase. This will usually take place by transferring various fund investments from retirement phase to accumulation phase. The excess will be liable to a tax penalty for going over the cap.

Where a member has reached a condition of release such as retirement or reaching age 65, the balance of the TRIS at the time the person retires or reaches age 65 will be counted against the $1.6 million transfer balance cap. This is where people need to watch out as it is possible for a person to go over the $1.6 million transfer balance cap without their knowledge. It can happen to anyone merely because they have stopped a part-time or casual job once they are between 60 and 65.

Let’s consider 62-year-old Trevor. Trevor has a balance in his superannuation fund of $1.7 million. He has a full-time job as a sales manager and decides to take time off to work for the Electoral Commission on a casual basis to assist at the polling booths on election day. The work for the Electoral Commission lasts for a few weeks and usually ends after all the votes have been counted. As Trevor is at least 60 years old and stopped his work with the Commission, he is considered to have retired. In this situation, Trevor meets the retirement condition of release and the TRIS he was receiving will auto-convert to an account based income stream. The balance of the account based income stream will be counted against the $1.6 million transfer balance cap. As Trevor has exceeded his transfer balance cap by $100,000 it will be subject to an interest penalty.

Anyone who has commenced a TRIS and is nearing 60 or older needs to be aware of the issues relating to their superannuation that could arise if they are nearing retirement or when they reach age 65. If the proposed changes become law, it would be worthwhile for an individual to have their situation reviewed so they don’t get caught out. This should be done before the proposed changes come into effect and each time a change in their work circumstances occurs.
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I am firmly of the view that the **ONLY** certain outcome of the US Presidential election is a **sustained increase in cross asset class volatility**.

Firstly, let me say we are far from convinced that the fact US equity markets didn’t “collapse” in the wake of Trump’s victory is a green light to buy risk assets. Far from it, it may well be giving us a chance to lower our weightings from risk assets into what could prove a “sugar hit” that fades with time.

It would appear very few funds were positioned for a Trump victory. Even those few who were, would have been surprised by the market response. We are of the view you are watching a forced positioning unwind and it is premature to assume what you have seen is a sustainable market reaction.

We are also of the view that knee jerk reactions will **NOT** add overall value to the portfolio. This requires patience and conviction with the risk of losing money arguably higher than the risk of making money in the short term.

The AIM Global High Conviction Fund exited all our US technology equity holdings a week before the US election. We felt it was prudent to move onto the sidelines and we have remained on the sidelines as an aggressive internal rotation has occurred in US equities. The technology stocks we liquidated are all lower, some significantly, than the prices we sold them, which we feel vindicates our portfolio/risk reduction decision pre the election.

**Our only high conviction reaction to the US election was to increase our short position in US 30-year Treasuries.** We are of the view that Treasuries are a lose/lose and that short position in US Treasuries has broadly protected our long investments in structural growth equities around the world as bond yields have spike to reflect increased US sovereign risk, rising inflation expectations and heightened expectations of a Federal Reserve rate hike in December. We are high conviction shorters of the longest duration bonds, feeling our thesis of “real return free capital risk” has been triggered in long bonds by the Trump victory.

**US 30-year Bond yield chart**

To put in context how badly positioned for the sharp rise in bond yields Wall St was, not a single economist or analyst (65 analysts) forecast that US 10-year Bonds would be above 2.00% by year end. Today they are 2.22%.

**Why is the world demanding a higher interest rate for US debt?**

Quite simply because they think the new US government will issue buckets of long-term government debt to grow the economy via industry exposure. That would also drive inflationary pressure which is the worst enemy of a long bond.

Trump’s economic proposals would result in $5.3 trillion of borrowing and push America’s debt burden to 105% of its gross domestic product, up from 75% of GDP now.
Those numbers are not counting the extra $10 trillion of debt the government will need to cover the rising costs of programs like Social Security & Medicare over the next decade. Net annual interest costs alone are expected to almost triple by 2026.

In my view Trump has brought forward the end of the 35-year bull market in bonds. It’s that simple and we are positioned for bond yields to continue to rise, with widespread implications including for US mortgage rates which are based off the 30-year bond rate.

We also short “long duration” and “bond proxies” in the equity market, with short positions in the Real Estate Investment Trusts (REIT), Infrastructure and Healthcare sectors globally and locally.

We are also watching the negative price action in Junk Bonds (JNK), High Yield Credit (HYG) and Emerging Market (EEM) ETFs, which were the trigger for a deep developed market equity correction in January/February this year. The big question is whether the bond/credit sell off spreads to equities other than the obvious bond sensitive equities, which have been falling.

While we have moved to the sidelines in US technology equities and increased our short position in US Treasuries, we have increased our exposure to certain China-facing consumer equities listed in Hong Kong. We have also increased our exposure to certain Australian industrial growth stocks that have already corrected.

On that basis it was encouraging to get a profit upgrade from APN Outdoor (APO) and strong AGM commentary from Treasury Wine Estates (TWE). Both stocks rallied strongly off recent lows on confirmation of solid outlooks. We await Aristocrat’s (ALL) full year results later this month which we feel should also be very strong. ALL is down -11% this month which we believe will prove an overreaction.

Other Australian stocks we feel other excellent risk/reward potential lies in Link (LNK) and Star Group (SGR). Our approach is to buy and hold stocks that have been oversold in this rotation and wait for earnings and dividends to arrive to confirm our bullish views.

This is NOT the time for passive strategies. In fact, passive bond strategies are experiencing capital losses. In equities, at this moment in time the indices mask a deterioration in market internals that could well lead to indices correcting and passive strategies generating capital losses and underperformance.

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Buy, Sell, Hold – what the brokers say
by Staff Reporter

In the good books

Alumina (AWC) Upgraded to Neutral from Underperform by Macquarie B/H/S: 1/5/1

Macquarie upgrades near-term price forecasts for alumina, although remains bearish over the medium term. The broker forecasts Chinese market deficits for alumina in 2017 and 2018, and the gap to be filled by international market.

The broker upgrades to Neutral from Underperform on the back of increased estimates. Target is raised to $1.50 from $1.00.

On the broker’s estimates the stock offers an attractive dividend yield but this collapses to around 1% after 2018, as Macquarie believes new refinery capacity will displace merchant alumina in the seaborne market.

Ausnet Services (AST) Upgraded to Overweight from Underweight by Morgan Stanley B/H/S: 3/4/0

Morgan Stanley anticipates regulated utilities will outperform contracted utilities, expecting a continued rotation away from bond proxies. The broker estimates a large opportunity for Australian energy infrastructure.

The broker expects more detail on the efficiency and growth targets when the company reports on November 18.

Morgan Stanley upgrades to Overweight from Underweight on relative valuation. Cautious industry view.

Carsales.com (CAR) Upgraded to Buy from Hold by Ord Minnett B/H/S: 5/1/1

After the share price fell, as the company signalled that the first half revenue and EBITDA would be substantially below FY16 for the Stratton business, Ord Minnett suggests investors have over-reacted.

Management has indicated the issue is unique to the lender involved and not related to the wider industry. The broker upgrades to Buy from Hold, envisaging quality in the core business and options in the international investments.

Charter Hall (CQR) Upgraded to Neutral from Sell by UBS B/H/S: 0/2/4

After a challenging reporting season, in which the stock underperformed the sector, UBS anticipates that the presence of Shopping Centres of Australasia (SCP) provides some downside protection.

Combined with the current valuation after a sector wide pull-back, the broker can no longer justify a Sell rating and upgrades to Neutral.

National Storage REIT (NSR) Upgraded to Accumulate from Hold by Ord Minnett B/H/S: 2/1/1

The company’s decision to increase upfront rent concessions and introduce modest rental discounts to stimulate growth in occupancy should not be a negative for revenue, Ord Minnett believes.

If managed well, the company should be able to recover the decrease in average rental rate, recorded since June, over the next two years.

OzForex (OFX) Upgraded to Outperform from Neutral by Macquarie B/H/S: 2/0/0

First half underlying profit was down 22%. Macquarie
does not believe the business model is broken but that there is clearly lots of work to do to get it back on track.

The current valuation, post the sell-off, already appears to be discounting the prospect of achieving anything like revised FY17 guidance, in the brokers opinion, which would then provide an improved trajectory in the second half into FY18.

Macquarie believes the company’s active and lapsed client base, technology, licences and banking relationships should appeal to trade and financial buyers well above current levels.

Oz Minerals (OZL) Upgraded to Outperform from Neutral by Macquarie and to Buy from Neutral by UBS B/H/S: 3/3/2

Macquarie upgrades copper price forecast by 11-15% for the next four years and believes improving supply/demand fundamentals should provide some support for the recent rise in copper prices.

The broker incorporates the improved outlook, which drives material upgrades to earnings forecasts. The company is expected to swing back to profit in 2018.

The company has de-risked previously held views on Carrapateena and provided a resource update for Prominent Hill, which extends the underground mine life to 2028.

UBS expects interest in the company to build now it has a business that is supported by two long-life Australian domiciled copper assets that, together, are expected to deliver average production of around 100,000tpa over the next 10 or more years.

This represents a marked turnaround from a year ago, and the broker upgrades to Buy from Neutral.

See downgrade below.

Premier Investments (PMV) Upgraded to Neutral from Sell by Citi and to Neutral from Underperform by Credit Suisse B/H/S: 0/6/0

Citi analysts have upgraded to Neutral from Sell following share price weakness. The official explanation is that risks are now much more balanced.

They do anticipate weak sales in H1, in particular from womenswear, but Smiggle remains the all-important offset. Target retained at $13.80. The company is cycling a very strong Christmas 2015 too.

Following small adjustments to estimates, Citi is now positioned 6% below consensus for FY17 and 3% below consensus for FY18.

Improving commodity prices are positive for national income and, thus, should provide a more supportive backdrop to consumer spending in the medium term, Credit Suisse observes.

While there remains some downside risks to earnings because of softer market-wide trading conditions in the first half, Credit Suisse upgrades its rating to Neutral from Underperform following share price weakness.

Sandfire Resources (SFR) Upgraded to Outperform from Neutral by Macquarie B/H/S: 4/3/1

Macquarie upgrades copper price forecast by 11-15% for the next four years and believes improving supply/demand fundamentals should provide some support for the recent rise in copper prices.

The broker incorporates the improved outlook, which drives material upgrades to earnings forecasts and the rating is upgraded to Outperform from Neutral.

Spark Infrastructure (SKI) Upgraded to Overweight from Equal-weight by Morgan Stanley B/H/S: 4/2/0

Morgan Stanley anticipates regulated utilities will outperform contracted utilities, expecting a continued rotation away from bond proxies. The broker estimates a large opportunity for Australian energy infrastructure.

Spark Infra provides a good simple yield, in the broker’s opinion, underpinned by high quality regulated assets.
Webjet (WEB) Upgraded to Buy from Neutral by UBS B/H/S: 3/2/0

The company will sell the Zuji business in Hong Kong and Singapore for $56m. This compares with the purchase price of $30m. UBS notes the incoming cash for the deal will offset $36m cash upload for the recent Thomas Cook tie up.

The broker notes trading to date has been strong for FY17 and guidance for EBITDA from continuing operations is $60m. UBS upgrades forecasts by 1-2% for FY17-19.

Woolworths (WOW) Upgraded to Buy from Hold by Deutsche Bank B/H/S: 1/2/3

Woolworths has made large investments to re-start growth and Deutsche Bank believes the turnaround is beginning. The broker’s survey suggests shoppers are seeing improvements in price and execution and are buying more groceries.

Store location remains the main driver of shopper behaviour, which should provide the company with a long-term competitive advantage in the broker’s opinion.

Deutsche Bank upgrades to Buy from Hold on the basis that competitors, such as Wesfarmers (WES) and Metcash (MTS) should experience erosion of growth as Woolworths improves.

In the not-so-good books

APA Group (APA) Downgraded to Underweight from Overweight by Morgan Stanley B/H/S: 2/3/2

Morgan Stanley anticipates regulated utilities will outperform contracted utilities, expecting a continued rotation away from bond proxies. The broker estimates a large opportunity for Australian energy infrastructure.

While expecting the final outcome of this year’s gas market reviews will be benign for APA, the broker believes changes to the coverage test could take around 12 months to implement and this is unhelpful for share price sentiment and growth prospects in the near term.

Beacon Lighting Group (BLX) Downgraded to Hold from Add by Morgans B/H/S: 0/1/0

Morgans expects the first half result will be affected by soft like-for-like sales growth because of the aggressive clearance activity by Masters as it exits the market.

It will also be affected by lower gross margin in response to the lower Australian dollar/hedge rate and lower operating cost leverage.

This should be partially offset by the acquisition of three franchise stores in the first half. With the stock trading within 10% of the broker’s new target, the rating is downgraded to Hold from Add.

Duet Group (DUE) Downgraded to Equal-weight from Overweight by Morgan Stanley B/H/S: 2/3/2

Morgan Stanley anticipates regulated utilities will outperform contracted utilities, expecting a continued rotation away from bond proxies. The broker estimates a large opportunity for Australian energy infrastructure.

The stock remains the highest-yielding under coverage which the broker believes rewards investors for the manageable merchant and refinancing risk.

The broker downgrades to Equal-weight from Overweight as the downside risk is envisaged deepening with the valuation headwind.

Metcash (MTS) Downgrade to Sell from Hold by Deutsche Bank B/H/S: 4/1/2

Deutsche Bank believes the recent period of stabilising sales has been enabled by the loss of market share experienced by Woolworths (WOW).

Accordingly, as the sales trajectory improves for Woolworths so the broker expects independent supermarkets to come under increasing pressure.

Oz Minerals (OZL) Downgraded to Underperform from Neutral by Credit Suisse B/H/S: 3/3/2

Credit Suisse found the cost accounting for the Carrapateena pre-feasibility study did not add up.
Management has now reconciled some of the modelling.

The broker is still sceptical regarding some of the numbers but revises earnings and valuation to reflect the implementation of a revised model now that substantial differences have been explained.

There remain several unresolved risk factors regarding the project and Credit Suisse downgrades to Underperform from Neutral.

See upgrade above.

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Questions of the week – dividend-payers and Telstra
by Questions of the Week

**Question:** We have a SMSF and have not done fantastically out of share investing, which is why we joined the Switzer Super Report after following Peter for a while on his Foxtel business show.

We have now accumulated $200,000 cash to invest and need good dividend-paying companies, as we are both over 65 and retired.

I note your preference in the banks for CBA, of which we have 1200, and many more NAB.

**Answer (by Paul Rickard):** Understanding your preference for dividends, I would suggest the major banks, companies like Transurban (TCL) and Sydney Airport (SYD) (largely unfranked), ASX (ASX), Telstra (TLS), AGL (AGL), Boral (BLD), Wesfarmers (WES) etc.

That said, I prefer a portfolio approach and think you need to have some exposure to most sectors, including materials and energy. Have a look at my income portfolio – see here – which is keeping pace with the market and will yield a touch over 5%, franked to about 90%.

The other option, if it is all too hard, is to consider a broad based LIC that targets dividend growth companies. Consider companies like Milton Corporation (MLT), Argo (ARG) and AFIC (AFI).

**Question:** You stated that Telstra (TLS) would move to $6.00 and show good return. At the present time TLS is heading south very quickly and I would ask the question what do you think will happen.

**Answer (by Paul Rickard):** We were wrong on Telstra going to $6.00. The market is viewing the company as “ex growth”, is concerned about a potential revenue hole post the NBN, and fears that some of the technical outages that Telstra had earlier this year will impact customer retention and undermine its key competitive positioning – network reliability.

The brokers remain neutral to negative, with 5 holds and 3 sells. Due to Telstra’s recent share price performance, the consensus target price of $5.12 is now about 8% higher than the current share price. It is trading on a multiple of 13.7 times FY17 earnings, 13.1 times FY18 earnings, forecast dividend yield is 6.7% plus franking credits.

Am I selling at $4.71? No, I think the stock is fundamentally cheap and I don’t need the cash.

Will it go up in the short term? Probably not – it is just out of favour, and while bond yields are rising, it will stay this way. If the bond market steadies, expect to see some more value hunters.

My advice – hang in there, but if you want some stocks to move with the market in the short term, it is probably not Telstra.

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