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On... the resumption in US growth, the UK's ongoing recession, Asia's bullish FX outlook, beware the US' equity downside, US earnings surprises, the surge in Asian equity issuances, the rise in new refining construction, mining's capex comeback, still tough in US coal, Aussie steel pressure, there's good news in US autos, downgrading HSBC, the case for US REIT M&A, plus a new generation in Aussie utilities:

Economics and Currencies

The resumption in US growth

'**The bottom line**', *determines **US Economist** Bob DiClemente*, 'is that while the core of the economy is growing at a slower pace in the second half than the headlines may indicate, the underlying trajectory of growth is likely to improve gradually over time… so abstracting from the auto- and energy-driven distortions, **our view of recovery's path is consistent with the slow and steady repair of financial conditions**, which are vastly better than their recession lows but still exerting a restraining force on spending… financial conditions will continue to recover and the gradual, steady pickup in growth will be sustained… **Q3 GDP likely will provide the first concrete data that growth has resumed**'. ⏩

The UK's ongoing recession

'UK recession not over', *rues **Economist** Michael Saunders*, 'for the ONS report that GDP fell 0.4% QoQ in Q3, the **6th consecutive quarter of decline**... **in contrast to our and consensus forecast** of a 0.2% gain... this leaves GDP down by 5.2% YoY and down by 5.9% from the pre-recession peak, making this clearly the **deepest recession of the postwar period**... surprising, in the light of recent surveys and data... thus, whereas we suspected the MPC would probably not extend QE further at the November meeting, or if they do it would just be a token £25bn or so over 2-3 months to gradually phase out the QE buying, now, we believe it is a far **more balanced call**... especially if it takes the view it's safer to do too much stimulus rather than too little'. ⏩

Asia's bullish FX outlook

'**It's hard not to be bullish on Asian FX**', *declares the **Asia Macro and Strategy Outlook***, 'with economic rebound, rising inflation momentum and rising interest rate differentials, all supportive of FX strength... furthermore, while still negative output gaps and limited demand-pull inflation does buy time for Asian central banks to delay rate hikes till '10, the **RBA's recent surprise action as well as the sharp commodity price reversal** is fueling "risk" that central banks in Asia may have to **hike rates more preemptively** (ie. by more) than what we were initially expecting... so much so, we have **brought forward our timing for a rate hike** in Indonesia to March, while expecting larger initial hikes in Korea... we also think risk has risen of earlier hikes in India and Thailand... and, like the domestic demand driven economies that can tolerate FX appreciation when inflation rises – ie. Indian rupee, Indonesian rupiah and Philippine peso, as well as the early rate hikers - Korean won'. ⏩

Top Down Analysis

Strategy

Beware the US' equity downside

Report of the Day

'The risk/reward scenario is not constructive for equities at this juncture', *warns **US Strategist** Levkovich*, 'even in the face of good quarterly earnings reports and the probability of more to come... with the S&P500 now up ~60% since Mar-09, putting itself in the running for the **4th best one-year gain following a bear** market trough since 1929, despite the current “Great Recession” being quite different to the Great Depression on various measures including the lack of an 86% market drop... also, in addition to the percent of upward revisions moving above the **very worrisome 70% level**, the bottom-up consensus estimates calling for 27% EPS growth in '10 requires a **sharp bounce in operating profits that seems unsustainable** without a broader based sales pick-up... another simple market indicator we watch is the percentage of NYSE stocks that are at or below their 200-day moving average, which at a current 10% reading is similar to the **level in early '04 when equity indices traded sideways** for the first 9 months of that year'.

US earnings surprises

'**It's still early in the reporting season for US small- & mid-caps**', *adds **Strategist** Lori Calvasina*, 'but these indices seem to be **off to a rocky start**... just 25% for the Russell mid cap index, 17% of the Russell 2500, and 16% of the Russell 2000, have so far reported, but the EPS “beat/miss” ratio stands at 3.8x for mid caps, 2.9x for the 2500, and 2.6x for small caps... this compares with ~2/3’s of the DJIA and 35% of the S&P500 that have reported 3Q09 earnings as of Oct 23, with an EPS “beat/miss” at 9x for the DJIA, and 5.8x for the S&P500... notable also, while investors have been saying they wanted improvement in top line trends as evidence that demand is stabilizing, at all size levels, **EPS beats continue to be much more prevalent than revenue beats'**.

The surge in Asian equity issuances

'Net Asian fund inflows have continued to lag', *monitors **Asian Strategist** Elaine Chu*, 'not just GEM funds, but also Global funds... last week no exception: US$781m of new money to offshore Asian funds was less than a third of the inflows to GEM funds; 37% below Global funds; and 10% smaller than the amount taken in by even Latin American funds - whose AUM are just a quarter of Asian funds... Asia's strong equity issuance a key hindrance: total cash calls (both IPOs and secondaries) have reached US$54bn in Asia ex over the last 3 months... this is **3.6x the funds raised** in Latin America, Emerging Europe, Middle East and South Africa, combined... looking ahead, while **Asia's equity issuance pipeline remains big** and should continue to absorb excess liquidity in the markets, with inflows to GEM funds now close to their previous Oct-07 peak, we see **possible money flows coming from GEM to Asian funds'**.

Global Sector

Energy

The rise in new refining construction

'**With 65% of new refining construction currently taking place in China, India and the Middle East**', *accepts **US Refiners** analyst Faisel Khan*, 'we estimate 4.9 mmbls/day of global refining coming on line by 2014… a potential **headwind for refiners**: assuming demand for oil grows at 1.2% a year, the current level of capacity additions will keep global utilization at 82% - **too low for refiners to have pricing power**… especially if the capacity in Asia targets US markets… at this point, our general belief is that the vast majority of new capacity in Asia will supply local markets… and while we do see a scenario where **US and European refinery shut downs** actually bring capacity into balance in the US, our glimpse into the 4Q shows refiners, on average, continuing to operate at a **loss for a third quarter in a row'**.

Materials

Mining's capex comeback

'Capex makes a comeback', *observe* ***Commodities Strategists*** *Heap & Tonks*, 'for Citi's global **metals and mining capex estimates has increased ~20%** since Mar-09 for stocks under coverage... the greatest absolute changes has come from diversified miners (+US$2.7bn), followed by aluminum (+US$2.2bn) and gold producers (+US$2.1bn)... and the most significant relative changes in aluminum (up ~3-fold), gold (up ~2-fold) and nickel (up ~2-fold)... not unexpected: the rapid recovery in commodity prices means **more projects become more viable**... higher capex notwithstanding, it's supply that differentiates our commodity preferences... **copper is our preferred metal**... and **coking coal is our preferred bulk** commodity, given continued infrastructure constraints'.

Still tough in US coal

'**Coal inventories remain at record levels**', *worries* ***US*** *analyst Brian Yu*, 'ending August at 194m tons (+37% YoY)… the only modest bright spot is that the YoY inventory build of 52m tons is the same in Aug as July, perhaps signaling marginal supply and demand are coming back into balance… still**, 67 inventory days remain too high** and well above the 5-yr average of 45 days… power generation declining 2% YoY - led by **lower Industrial power sales** - not helping… nor is **coal-to-gas switching**, **which remains high** and unlikely to reverse until spot gas prices recover to ~$6/MMBtu… regardless, we do see companies with a history of free cash generation that own low-cost mines and have exposure to **the tight met coal market doing well**… as per our Buys on CONSOL, ANR and Peabody'.

Aussie steel pressure

'**Our most recent checks with domestic steel distributors**', *cautions* ***Australian*** *analyst Julian Bu*, 'continue to point to **pricing pressure and uncertain demand**... as lower import offers, following **weakness in regional prices**, place increasing pressure on domestic prices... pressure, our industry contacts expect to last **through 1Q10 at least**... with the rising A$, and demand that has been supported recently by **restocking, now mostly complete**... one distributor in particular, was quite puzzled by Bluescope's running near full capacity - given it is a top customer, has seen sales improve, but they are still well down from normal levels by ~30%... thus, we suspect Bluescope is selling more into Asia, which has lower margin and is potentially less sustainable... furthermore, as we don't find the sector to be attractively valued, we **stay cautious**'.

Consumer Discretionary

There's good news in US autos

'**Our latest channel checks**', *concludes* ***US Autos*** *analyst Itay Michaeli*, 'suggest October SAAR running slightly ahead of 10m units, up from September's 9.2m... this would mark the **3rd highest SAAR of '09**, behind August (Cash for Clunkers) and July (11m)... and, we would view a **10-10.5m October SAAR as supportive** of a gradual recovery in demand, with **anything above 10.5m as outright positive**... amongst the OEMs, we expect strong sequential share performance at each of the Detroit 3, with the **Japanese lagging**... nonetheless, as auto stocks have already benefited YTD on the detoxification of auto risk via government-led OEM restructurings and improving auto sales, we'd **remain selective going into Q3 earnings results**... with a preference for higher-quality suppliers'.

Financials

Downgrading HSBC

TOP CALL OF THE DAY

'**While the market cap of the bank sector in Europe and the US is still only about half its previous peak levels'**, *confirms analyst Ronit Ghose*, 'and **Japan is only at about a third** of its historical peak level achieved in Apr-06, several large emerging market bank sectors are back between 80% and 100% of their historical peaks... **India, Brazil, Turkey and China leading the way**... stands to reason, **Standard Chartered, HSBC and Santander, have all recovered** to be valued at or above previous peak market cap levels - all 3 are internationally active retail and commercial banks... and, HSBC and Santander are expected to earn net profits in '10 and '11 in line with their '06 pre-credit crunch levels, whilst Standard Chartered is expected to earn profits considerably above pre-credit crunch levels... nevertheless, as much of this also appears priced in, we add to our existing 'Hold' on Standard Chartered, with the **downgrading of HSBC**... preferring both Buy-rated BBVA - which remains at two-thirds of its previous peak market cap despite its Latam-driven recovery exposure - and Santander'.

The case for US REIT M&A

'**The resumption of M&A in corporate America**', *acknowledges **REIT** analyst Michael Bilerman*, 'raises the question on whether the REIT industry could follow... the quick answer is 'no' – infact, we continue to expect to see the reverse, more public companies rather than less... the wave of equity issuances over the last 6 months to pretty much every company – broken or not – has **allowed many companies to "survive"** rather than having been forced into a merger with a larger cap company... and certainly, **no one wants to "sell in 09" at what could be perceived as the bottom**... but, at the same time, "out of the box" M&A scenarios deals can and do always occur... so in this report, we detail our **M&A thoughts overall and by sector**... looking specifically at whether BXP or VNO could merge with DEI?... and/or if we could see the emergence of a large diversified REIT with VNO expanding its retail presence?'.

Utilities

A new generation in Aussie utilities

'**Australia's 20% by 2020 expanded Renewable Energy Target (RET)**', *scribes **Utilities** analyst Marie Miyashiro*, 'will add **another dimension to new investment** decisions in the electricity industry... in the earlier years, with wind currently the only form of large scale renewable energy that is technologically and economically viable, we estimate the mandated target would require ~11,000MW of **additional wind development or ~$30bn** in capital investment... further into next decade, **geothermal, if proven feasible, may dominate new renewable build**, displacing new wind investment... whilst carbon, a new commodity, being (partially) internalised in the wholesale cost of electricity (CPRS), will add another layer of complexity... a 'new generation', all 3 exposed listed companies, AGK, Infigen and Origin have positioned for... thus, while it's still too early to incorporate our forecast black and green energy prices into the various companies' hedge books, we believe RET and likely legislation of the CPRS will ensure the optionality in these companies' (renewable & gas) development pipelines is preserved'.

Appendix A-1

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