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COMMENTARY – A great time to rebalance portfolios

While global economic outlook has improved, consider strategies to mitigate downside risk

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With the deadline for RRSP contributions less than 10 days away, this is the time of year when many investors typically turn their (annual) attention to their investment portfolios. We would suggest that there is added impetus to that review exercise at present, given that US equity indexes are at multi-year highs and the outlook for the global economy has improved considerably since late last year.

Much of that improved outlook has been predicated on a better outcome to the European sovereign debt situation than was expected in the second half of 2011. But as we have seen on numerous occasions in recent years, it does not take much to trigger a complete turnaround in investor sentiment and send markets on a downward path yet again.

At the present time, we strongly recommend that investors take adequate time to review their portfolios and rebalance them, based on their investment objectives, risk tolerance levels and investment horizon. This may necessitate taking profits in certain sectors that have done very well in recent months, and initiating or adding to positions in sectors where good value is abundant.

The barbell approach to equities that we have been advocating for a few months now looks particularly appropriate at the present time, as measured risk appetite makes a comeback.

Bottom-Line: We suggest investors consider trimming positions in sectors that have been red-hot recently, such as US technology and biotech. We have also turned somewhat cautious on sectors such as Canadian telecom and utilities, which have been stellar performers in recent years due to their defensive characteristics, but may now be due for a pullback.

We have lately been advocating the use of option collars to hedge downside risk. This strategy involves writing covered calls and buying out-of-the-money puts with the call proceeds. If that tactic seems too complicated, buying near-term protective puts is a simple strategy worth considering, especially with volatility abating very significantly since October.

In our opinion, there continue to be a substantial number of Buy candidates in sectors where the sell-off in the frenetic two-month period from August to October 2011 was hugely overdone. As can be seen from Figure 1 below, two such sectors are Energy and Materials, which have had double-digit declines over the past year, but in our opinion, are prime candidates for a rally as the global economy continues to rebound.

Figure 1: TSX one-year group performance



Source: Bloomberg

(New Recommendation) Buy Alcoa – target \$13.50

We recommend buying **Alcoa (NYSE: AA, \$10.14)**, the world's leading producer of aluminum, based on our view that the stock may have significant room for a rally as the global economy strengthens. Alcoa has rebounded about 20% from a 2½ -year low of \$8.45 reached in October, but is still 45% away from its multi-year high of \$18.47 posted in April 2011.

The stock has followed aluminum prices lower since May 2012 (Figure 2). Three-month aluminum prices had peaked at over \$2,800 per metric ton in May before sliding 30% to below \$2,000 by mid-December. They have since rebounded 10% as the outlook for the global economy looks more positive now than it did late last year.

In January, Alcoa reported its first quarterly loss in more than two years, precipitated by aluminum prices slumping by an average of 11% in the fourth quarter compared with year-earlier levels. The company reported a loss from continuing operations of \$193 million or \$0.18 per share, mainly due to restructuring charges, lower aluminum prices and continued weakness in Europe.

The Q4 loss included \$159 million of restructuring charges (of which approx. 60% is non-cash) associated with the closure or curtailment of 531,000 tons of high-cost production capacity. Excluding restructuring charges and other special items, the loss was \$34 million or \$0.03 per share. A year ago, Alcoa had reported income from continuing operations of \$258 million or \$0.24 per share. Q4 revenue of \$6.0 billion was up 6% from a year earlier but down 7% sequentially.

Despite the unsettled markets, Alcoa managed to meet its financial targets in Q4. It generated \$656 million in free cash flow in the quarter, four times higher than in Q3, while cash from operations more than doubled over Q3 levels to \$1.14 billion. Alcoa also improved liquidity and efficiency in Q4, with cash on hand rising 46% from Q3 levels to \$1.9 billion, and days of working capital at a record low of 27 days at end-Q4, 3 days lower than in 2010.

For full year 2011, revenue rose 19% to \$25 billion, with income from continuing operations more than doubling to \$614 million or \$0.55 per share (\$0.72 ex-items). Alcoa generated \$2.2 billion in cash from operations in 2011, little changed from 2010, and \$906 million in free cash flow.

Alcoa's capital spending amounted to \$1.3 billion in 2011, 86% of its target. It finished the year with a debt-to-capital ratio of 35%, at the upper end of its targeted range of 30%-35%, due to the negative impact of a significantly lower discount rate on its pension plan liability.

The smelting capacity of 531,000 tons that Alcoa has taken off the market represents 12% of its total capacity. It includes 240,000 tons, or 5% of its global capacity, of curtailments at Alcoa's smelters in Italy and Spain, as well as the previously announced closure of a smelter in Tennessee and two lines at a Texas smelter that collectively account for another 291,000 tons of capacity reduction.

Alcoa expects a global deficit of 600,000 metric tons in primary aluminum supply in 2012, due to production cutbacks coupled with forecasted growth of 7% in global aluminum demand. This is a slower pace of growth compared with 10% in 2011 and 13% in 2010. However, Alcoa notes that its 7% growth estimate for this year is a little ahead of the 6.5% annual growth rate required to meet its forecast for a doubling in global aluminum demand between 2010 and 2020.

Analysts are forecasting a 26% drop in EPS this year, with the average at \$0.53. However, earnings growth is forecast to rebound strongly over the following two years, surging 68% to an estimated \$0.89 in FY13 before slowing to half that growth pace to \$1.20 in FY14. On that basis, the stock trades at forward multiples of 19.1x FY12 forecast EPS and 11.4x FY 13 EPS.

Revisions in those EPS estimates – whether upward or downward – will depend on how aluminum prices fare over the year ahead. The bullish case for aluminum assumes that price form a base at current levels (\$2,000 - \$2,200 per metric ton) and move higher. Consensus estimates for 2012 are for aluminum prices to average \$2,638 in 2012, which would represent an increase of about 4% over the average price of \$2,503 in 2011.

However, consensus estimates are significantly higher than pricing off the forward curve for aluminum, which shows an average aluminum price of \$2,250 in 2012. Our view is that as long as no additional shocks emanate from Europe, the global economy should be able to post steady – if sub-par – growth, which would be positive for aluminum prices.

We believe the risk-reward payoff for Alcoa is very favourable at the present time, with downside risk of perhaps 20%, more than offset by potential price appreciation to the mid-teens over the next couple of years. Our target price on Alcoa is \$13.50, derived on the basis of a P/E of 14.5x (which is the median multiple over the past four years) applied to FY13 EPS of \$0.89. The stock pays a quarterly dividend of 3 cents, for an indicated yield of 1.2%.

Figure 2: Alcoa vs. aluminum prices* – 2007 to 2012 (weekly)



Source: Bloomberg

*LME 3-month rolling forward

Market Snapshot at 12:10

S&P TSX	12456.30	-29.29	Commodities			Yields (%)		Can.	US
TSX Venture	1654.01	+5.90	Canadian \$	1.0041	+0.0008	90 Day T-Bill	0.93	0.08	
DJIA	12954.11	+50.03	Gold (Spot)-US\$	1723.88	-4.20	2-Year Bond	1.09	0.29	
S&P 500	1360.94	+2.90	Oil (WTI-March)	103.44	+1.13	10-Yr. Bond	2.05	2.01	
NASDAQ	2950.53	-9.32	CRB Index	317.39	+0.98	30-Yr. Bond	2.63	3.16	

Thought for the Day

“Dance like it hurts, love like you need money, work when people are watching.”
– Scott Adams (“Dilbert” creator)

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