

Weekly Outlook



22 May 2006

Brief Market View

Equity markets continued to slide last week after US economic data showed the pace of inflation accelerated in April, boosting speculation that the Fed will raise rates longer than Wall Street had expected. Weakness in the basic resources and oil sectors remains a dominant theme. Gold prices tumbled on Friday as a sharp rise in the dollar against major currencies sparked a major sell-off in the metals market. Gold has fallen 10 percent in a week from its 26-year high of \$730 hit last Friday when speculators had poured money into the metal on a weak dollar outlook and inflationary concerns. The sell-off was seen in other markets too, with copper falling over six percent. Aluminium and zinc also dropped. The list of worst losers on the FTSE 100 last week was comprised of nearly all listed resource/mining stocks. These sectors together, account for 25% of the FTSE 100 and accounted for at least 50% of the rise in the FTSE 100 in the first four months of the year.

We remain of the view that the Fed's interest rate hike cycle will likely pause in June, but we also acknowledge that the Fed's sensitivity to inflation has increased and that signs of inflation are unlikely to ease soon. In last week's Outlook document we mentioned that the corrections that we are currently experiencing are typically 5-9% in severity, but with European markets now down by some 7 percent since their YTD highs we believe that the correction may be close to or at its end.

This is a sentiment correction not a anan earnings event and we remain upbeat on the fundamentals behind equities. Earnings upgrades are continuing at a solid pace as Q1 reporting has strongly surprised to the upside. The dividend yields of stocks are higher than historic norms. Corporate debt spreads show no deterioration in fundamentals. P/e's are not very demanding. Nonetheless, should the next couple of weeks continue to show signs of rising inflation and strength in the economy, the market will likely continue to suffer. The market will strongly focus on any data release in this context.

In the week ahead, such worries are likely to remain and markets will therefore focus on the key inflation indicators scheduled to be released - the price index of the Q1 GDP report (Thurs) and, more importantly, given its unofficial status as the Fed's preferred measure of inflation, the core personal consumption deflator on Friday. Markets are expecting a 0.3% rise on the month, and a stronger number will keep inflationary concerns at the forefront.

While markets do present difficulties, they also provide opportunities to find lower entry levels into preferred sectors and stocks, but it also helps investors evaluate the make-up and risk profile of their current portfolio.

The stocks that will find most favour in the current period of market weakness are those with solid earnings with an attractive valuation and attractive yield. As a result we favour banking stocks (HBOS, Bank of Ireland), pharmaceuticals (GlaxoSmithKline, AstraZeneca), telecoms (BT and Vodafone), oil (BP, Sterling Energy) and insurance (Aviva, Legal and General). Also with the oil price weakening the stocks like Ryanair and British Airways, both of which are extremely profitable, should benefit.

In terms of corporate events to keep an eye on this week, British Land, M&S and Viridian all report FY results on Tuesday, Kingfisher releases interim results on Wednesday, on Thursday Daily Mail & General's interim results will be watched for any read through to IN&M, Cable & Wireless also releases FY numbers on the same day, and lastly, on Friday Barclays will release a trading statement.

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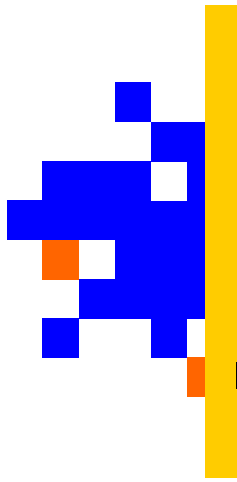
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23-May	M&S	FY
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Upcoming events

30-May	Vodafone	FY
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Trading ideas for the week

Apple (\$64.51) Attractive entry level

- Recent weakness: Shares in Apple have dropped by almost 10 percent over the last 7 days in the wake of overall market weakness and news that fellow MP3-player manufacturer, Creative has filed patent complaints against the company. The share price weakness overshadowed news of Apple's continued transition to using Intel microprocessors with the release of its new MacBook line of consumer-laptop PCs. But with the company expected to benefit from a modest seasonal sales boost over the current quarter and as it approaches the completion of its transition to Intel microprocessors, we believe that the recent weakness provides an attractive buying opportunity.
- Law suit: Creative Technology is seeking to halt the import and sale of iPods in the US on the grounds of patent infringement. The lawsuit is the latest in a series of legal challenges to Apple. But investors can draw comfort from Apple's strong track record of successful legal defences. Apple recently fought off a lawsuit in the UK by Apple Corps, the Beatles' record label, which had sought to stop Apple using the Apple name in connection with the iTunes service.
- Q2 Results: Apple reported a strong set of Q2 results on April 19. The highlight of the results was a better than expected PC shipments number. Apple reported that 1.1 million PC units were shipped in the quarter on the back of a strong uptake of new Intel-based iMacs, MacBook Pros and Mac minis. This would suggest that concerns over Apple's transition to Intel microprocessors have been exaggerated.
- Strong PC sales: We expect the launch of further Intel-based Macs and demand from the education sector (the majority of US schools purchase their computers for the year ahead in the June-end quarter) to stimulate further growth in this area for Apple. Apple is expected to complete its Intel transition by the end of this year. Over the coming weeks Apple is also likely to benefit from a seasonal boost of 'Dads and Grads' purchases. Sales of iPods over the months of May and June would indicate that they are popular gifts for university/school graduates and Father's Day.
- High growth: Our current 12 month price target of \$75 is based on 25x 2007 eps of \$3. While this would represent a significant premium to sector average of 15x, this would appear justified given Apple's superior earnings growth over its peers (30% vs sector average of 15%) : **BUY**

AstraZeneca (2,801p) Buying opportunity

- Short-term trading idea: Shares in AstraZeneca have underperformed recently on the back of a combination of disappointing developments for some of its potential blockbuster drugs and unfavourable currency movements, overshadowing impressive Q1 results reported at the end of April. Despite some concerns over the company's product pipeline and patent expiries, the company is underpinned by sound fundamentals and an attractive valuation, and the recent share price weakness presents a decent buying opportunity.
- Valuation: Earnings are expected to grow by between 10 and 15% in 2006 and 2007, however the shares trade on 14.7x 2006 earnings of \$3.71 and 14x 2007 earnings of \$3.91. This represents a discount of 20% to its European peer group, which seems severe given that pipeline issues exist for the majority of pharmaceutical companies. At current levels AstraZeneca is the most attractive yielding stock in the sector (3.0%), while during 2005 some \$4.7bn was returned to shareholders via dividends and share buybacks. For 2006 this figure is likely to increase to \$5.5bn.
- Upcoming newsflow: The upcoming business review day on June 8th is likely to focus on the recent positive outcomes data for Crestor and Phase II assets such as AZD2171 (cancer) AZD6140 and in-licensing activity. The company will report Q2 results on July 27.

AIB (€18.05) Upgrading from NEUTRAL to BUY

- Trading statement : This morning, AIB released a trading statement confirming that business in the year to date has been stronger than the bank's previous guidance, and that it is now targeting mid to high teens growth in adjusted eps, compared to its previous target of low teens growth. Growth of 17% this year would result in the bank reporting a 2006 eps of €1.71.
- Earnings upgrade : This represents a 4% upgrade to our previous 2006 eps forecast of €1.65, which implies a 4% upgrade to our current 12 month price target. As a result, we now upgrade our current AIB 12 month price target from €19.80 to €20.50, which is based on 12x 2006 eps of €1.71. Following the 11% fall in the AIB share price from its high of €20.20 on 27/02/06, there is once again attractive upside to this level, and so we upgrade our recommendation from NEUTRAL to BUY.
- Loan growth : The earnings upgrade is as a result of stronger than expected loan growth and better than expected credit quality. Previous expectations were for Irish retail loan growth of 20% and corporate banking loan growth of 15%. These growth rates have now been guided upwards to 25% and 20% respectively.
- Credit quality : AIB also confirmed that its credit quality remains very robust, with its 2006 bad debt charge as a % of average loans not expected to exceed 0.15%. The previous consensus market forecast was for a slightly higher bad debt charge this year of 0.18% of average loans. Particularly high recoveries of impaired loans will result in the H1 2006 bad debt charge being lower than 0.15% of average loans.
- Margin erosion : Despite the very strong loan growth resulting in an increased reliance on wholesale funding and an increased portion of lower margin mortgage lending, crucially AIB this morning re-iterated its previous 2006 margin erosion guidance for a 0.2% reduction in its net interest margin.
- Recommendation upgrade : Therefore, following this very strong trading statement and the 11% fall in the bank's share price in recent months, we now upgrade our AIB recommendation from NEUTRAL to BUY, with a new 12 month price target of €20.50 (14% upside), which is based on 12x 2006 eps of €1.71. AIB also pays a dividend yield of c.4% for waiting for this upside to be achieved : **BUY**.

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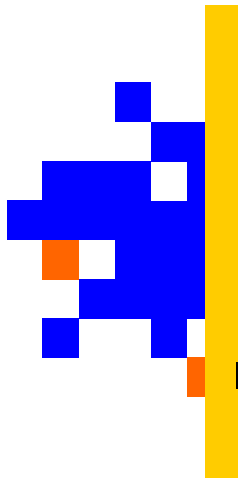
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Trading ideas for the week (continued)

BOI (€14.15) Preview of FY results

- Results preview: On Wednesday 31st May, Bank of Ireland will announce results for the year ended 31/03/06. We are forecasting underlying profit before tax and earnings per share of €1.39 bn and €1.18 respectively, both year on year increases of 15%. A final dividend of c.32.5c per share is expected to be declared going ex on 28th June, providing a yield of 2.2% on the current share price.
- Loan growth: Such strong earnings growth is being driven by very strong loan growth at both the group's Irish and UK mortgage and business lending operations, as well as buoyant life and pension trading conditions. Together with IL&P, BOI is the joint number one player in the Irish life and pensions market, and the buoyant trading conditions in this market should also help stabilise BIAM's profitability in 2006.
- Cost savings: BOI's cost reduction programme remains on course to achieve savings in excess of the €30m originally targeted for the current financial year. With the bank targeting a total reduction in group staff numbers of 2,100 by 2009, this annual cost saving should grow to €120m by then, providing a very useful offset to the lower margins and increased competition of the Irish bank sector.
- Life buoyant: Our view is that BOI's greater than average exposure to the buoyant Irish and UK mortgage and life & pension markets, when combined with its current cost saving programme should help drive further group earnings growth of 13% per annum over the next 2 years. This would generate a current year eps of €1.33 for the 12 months ending 31/03/07, growing to an eps of €1.50 for the 12 months ending 31/03/08.
- Problem businesses: This is because the profitability deterioration at BIAM and the start-up costs of the UK post office joint venture will be much less of a drag on group earnings than they have been over the past 12 months. BOI is also well placed to profit from the recovery in UK mortgage lending which is starting to take hold currently.
- Further upside: Therefore, we recently upgraded our 12 month price target to €16.50 (17% further upside), which is based on the current European bank sector average of 11x eps of €1.50 for the 12 months ending 31/03/08. When combined with the group's dividend yield of c.3.4%, this generates an attractive 12 month return for quite a low risk earnings profile: BUY.

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RBS (£16.93) Upgrading from NEUTRAL to BUY

- Management meeting: Following our recent investor meeting with Group Finance Director, Guy Whitaker, we are this morning upgrading our RBS recommendation from NEUTRAL to BUY. Our new 12 month price target of £20.50 (14% upside), is based on 10x 2007 underlying eps of 205p. Our 2006 eps forecast remains 190p, representing 8% growth on the 2005 result of 175.9p.
- Savings growth: In line with recent results from the UK life insurers, it was confirmed that sales of savings and deposit products are very strong currently, resulting in the bank's liability growth exceeding its loan growth. When combined with a steepening US yield curve, this should ensure that there is no further significant erosion of the group's net interest margin in 2006. This was one of the main reasons why we had been recommending some profit-taking in recent months.
- Deal risk: It was also clearly stated that all of the group's growth targets could be achieved organically from its UK and Irish, US and Chinese operations and that the current share buyback programme would continue. If the upcoming IPO of the bank's Bank of China investment results in RBS diluting its shareholding below 5%, then this could provide further reassurance that the risk of a major RBS deal over the next 12 months is very low.
- Personal exposure: Despite recent press coverage of the Q1 rise in UK personal insolvencies, it was also confirmed that RBS has suffered no material deterioration in personal lending credit quality recently. Its lower than sector average exposure to unsecured personal lending of c.7% of global loan book provides some important protection from this risk.
- Recommendation upgrade: In addition to the upcoming Bank of China IPO, which recent press coverage has reported will show a trebling of the initial value of the RBS investment a year ago, another near term positive catalyst for the RBS share price could be the bank's H1 trading statement on 8th June. Therefore, ahead of the very often seasonally strong month of June for the RBS share price, we this are this morning once again upgrading our recommendation from NEUTRAL to BUY, with a new 12 month price target of £20.50 (21% upside), which is based on 10x 2007 eps of 205p : BUY.

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Lloyds-TSB (499p) Attractive buying opportunity

- UK growth : Lloyds TSB announced profit before tax and eps of £3.47 bn and 44.6p respectively for the year ended 31/12/05. These results were ahead of consensus forecasts of £3.315 bn and 42p, and were year on year increases of 4% and 8%. The results showed modest retail banking growth and good cost control being less offset by higher bad debts than had been expected.
- SW recovery : The results also indicated that there has been no further deterioration in retail unsecured credit quality since the bank's trading statement in December, and that the outlook for Scottish Widows is continuing to improve. This business and Lloyds' Insurance and Investments division in general is benefiting from a strengthening UK life and pensions market, as well as increasing bancassurance volumes.
- Attractive yield : It is also worth noting that even though the 2005 bad debts charge as % of average loans was higher in retail banking, it was lower at the group's corporate lending operations as credit quality at the bank's Wholesale & International business remained strong. With an above average probability of a 2006 takeover approach, an attractive dividend yield of 6.8%, and a stand-alone ex-dividend fair value per share of £5.70, based on 12x 2006 eps of 47.5p, our view is that the market sell-off of recent days has generated a very attractive buying opportunity in Lloyds TSB at current levels : BUY.

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