

Weekly Outlook



30 May 2006

Brief Market View

Last week the FTSE 100 index posted its biggest weekly gain in over six months, ending a volatile week on an upbeat note as rallying banks, miners and oil stocks combined with moderate U.S. inflation data to put the market firmly in positive territory. Miners, the driving force behind the FTSE's recent swings, were among the biggest gainers. Despite the weekly increase, the FTSE 100 still stands nearly 6 percent below the five-year highs it struck in April. US stocks also brought an end to a two-week rout, with the Nasdaq returning to positive territory. The latest U.S. data helped to soothe some nerves as inflation and consumer confidence nearly matched expectations and were interpreted as doing little to increase the chance of another interest rate hike from the Federal Reserve in June.

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 6 percent since their YTD highs we believe that the correction may be close to or at its end.

This is a sentiment correction not an 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.

With few earnings reports due, the market will once again be focused on economic growth and inflation as we estimate the possibility of more interest rate hikes from the Federal Reserve. Next week's key data release is the jobs report, due on Friday. But traders also will get another read on consumer confidence, as well as reports on regional and national business activity and government data on factory orders and durable goods in the holiday-shortened week. Economists forecast the U.S. economy added 175,000 new jobs in May, after a 138,000 increase in April. The unemployment rate is expected to remain unchanged at 4.7 percent. When trading resumes on Tuesday after Monday's holiday, investors will get another look at consumer confidence. The confidence index compiled by the private Conference Board will likely show a reading of 101.1 in May, lower than the 109.6 registered in April, according to economists' estimates. On Wednesday, the National Association of Purchasing Management-Chicago will release its index of Midwest manufacturing activity. The index is expected to show a fall to 56 in May, from 57.2 in the prior month. Still, readings above 50 indicate economic expansion. On Thursday, the Institute for Supply Management will reveal its index on national economic activity for May. The index is forecast to fall to 55.5 from 57.3 in April. Also on Friday, after the jobs report, investors will get a reading for April factory orders and revisions to April durable goods data. Factory orders likely fell 2.2 percent that month, after a 4.1 percent jump in March, according to economists' estimates.

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, Vodafone reports FY results on Tuesday, but the unveiling of its new strategy and structure for the payment of its special dividend is likely to overshadow the actual reported numbers. Bank of Ireland reports full year results on Wednesday.

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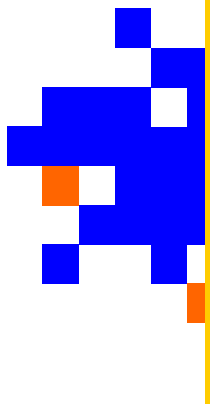
Earnings Calendar

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31-May	BOI	FY
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6-Jun	Ryanair	FY
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Trading ideas for the week

GSK (1,480p) To present key cancer data

- ASCO conference: GSK is to present important Phase III data for Tykerb at a high-profile cancer conference later this week and we believe that this event could act as a major catalyst for GSK's share price. GSK is well placed to benefit with data expected on a number of late stage pipeline assets. Data for Tykerb will dominate the ASCO meeting in Atlanta, and together with four other oncology assets will result in a high profile for the company. Although oncology has not been a traditional area of strength, we expect GSK to feature at ASCO with data expected on a number of its late stage assets: 1) First Phase III data is expected for Tykerb (breast cancer), for which positive headline data has already been presented. The data is expected to support regulatory submission in 2H 06; 2) First Phase III Cervarix (cervical cancer vaccine) data expected to be presented.
- Q1 Results: In late April GlaxoSmithKline reported better than expected results for the three months ended March 31st 2006, driven by strong sales of its key drugs and vaccines. Turnover and EPS of £5,813m and 26.5p were year on year increases (on a constant exchange rate basis) of 10% and 17% respectively, and were ahead of consensus forecasts of £5,625m and 23p.
- Growth drivers: The key drivers of the results were strong performances of GSK's big name medicines. Sales of its Avandia/diabetes (+24% to £384m vs £320m exp.), Coreg/heart disease (+53% to £225m vs £170m exp.) and Vaccine (+44% to £366m vs £312m exp.) products beat expectations, while Advair/asthma (+12% to £816m vs £860m) was slightly behind.
- Pipeline progression: GSK also reported 'significant progress' in its near-term drug development pipeline, with its cervical cancer vaccine Cervarix filed with EU regulators and 13 other markets in March and strong Phase III data on Tykerb, a new oral medicine for breast cancer. This should support an earlier than expected filing with European and US regulators in the second half of this year.
- Product launches: GSK possesses one of the most exciting R&D outlooks in the sector. The next 12 months will see a host of key updates hitting the market, including 8 new products expected to enter Phase III development, 7 regulatory filings and 7 important product launches. These updates will keep sales forecasts ticking upwards over the course of 2006.
- Further upside: Given that the sector is currently trading at 19x 07 EPS we believe that no more than a 10% discount for GSK is appropriate to reflect its slightly slower than average earnings growth and therefore, our 12-month price target price of 1,650p is based on 17x 07 EPS of 97p. The strength of GSK's pipeline remains the key driver of our investment case, and we expect to receive further evidence of its positive impact on earnings over the coming months. **BUY**

BOI (€14.32) 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 (15% 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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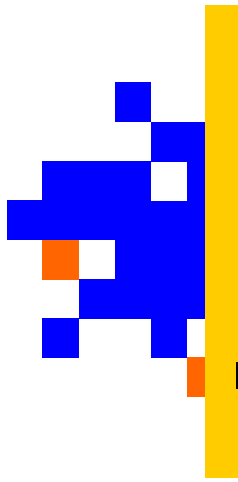
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Trading ideas for the week (continued)

AIB (€18.64) 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 (10% 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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RBS (£17.07) 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 (20% upside), which is based on 10x 2007 eps of 205p : **BUY**.

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Lloyds-TSB (502p) 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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