October 2016

Investment Watch

Cutting through the noise

Despite central banks staying the course with accommodative policies, many asset classes, both at home and overseas, encountered some turbulence over the past month, principally because markets started to confront the reality rather than the distant prospect of more-normal monetary policy in the United States.

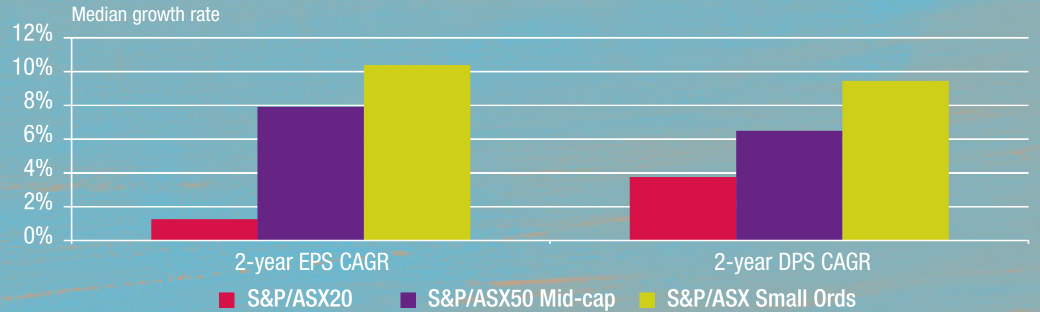
Many asset valuations made sense only when interest rates looked likely to remain very low and thus became vulnerable when questions arose as to when the tide will turn. There are likely to be further episodes of valuation reassessment in coming months as investors continue to rethink asset prices against a background of modest global economic growth. We look at the implications of rising interest rates in the context of our high yielding defensive sectors, Infrastructure (page 4), REIT (page 5) and Fixed Interest (page 6).

For the Australian share market, the deterioration in company earnings expectations appears to be slowing on the back of stabilising commodity prices. However, the post-Brexit rally into reporting season has propelled market valuations further to a historical high of 16x, making it difficult to see any further multiple expansion unless it is supplemented with a positive pick-up in earnings.

The AGM season will be critical to understanding the outlook for profits over the next six months. Unless we see a turnaround in company guidance, Australian shares are likely to face some headwinds from further episodes of external volatility. There have already been three instances this year where global equities were roiled by one concern or another (global growth/China, Brexit, and US Fed policy). There are likely to be further squalls along similar lines, and the domestic business cycle is not yet robust enough to enable Australian shares to ride out any future global sell-offs.

Apart from these episodes the market has continued to strongly support quality companies outside the top 20 market stalwarts, which continue to build their revenue and earnings bases despite the subdued economic environment. We highlight some of these opportunities in our high conviction list (page 7). Ahead of the AGM season we also highlight a number of upcoming catalysts (page 3).

Challenges remain for the ASX20 – better prospects in the small/mid cap segment

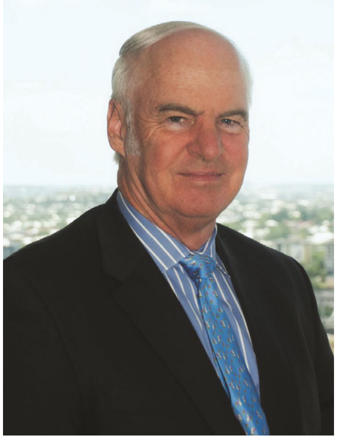


Source: Morgans, Bloomberg

Contents

This edition we look at ...

Visit our website to watch the latest network presentation from our Chief Economist, Michael Knox



Economics – Fed world

Every quarter, the 17 most senior members of the Federal Reserve System participate on an internal survey called the Summary of Economic Projections. Each participant in the survey provides their estimate of real GDP for the three years ahead; unemployment for the three years ahead; inflation for the three years ahead and core inflation for the three years ahead. Most importantly, they also provide their estimate of the Federal Funds rate at the end of each year for the three years.

They then publish each of the individual results without identifying which member of the Fed provided the estimate. They also publish a median of all of the estimates for each number. In this issue, we show the median estimates of each of the numbers from the survey conducted as part of the meeting of the Federal Reserve from 20-21 September. The estimates for the previous meeting in June are also shown.

Notable changes:

1. GDP growth is slightly down from the Fed estimate in June. In the long run, the Fed thinks that the US economy can continue to grow between 1.8-2.0%. We hope the future is so predictable.

> There is a very strong chance of one more rate hike by the end of the year.

2. Employment – We have mentioned previously that the Fed thinks the natural rate of unemployment is 4.9%. This is the level that it refers to as 'full employment'. Below this level, there is a moderate rise in inflation. The median estimates for the September meeting suggest that the Fed thinks it can stabilise unemployment at just under the natural rate for the next couple of years.
3. Inflation – The median estimate for core PCE inflation suggests that when we take away food and energy prices, inflation is actually already running at a higher rate and close to the Fed's target of 2%.

Implications for the Fed Funds rate

The median estimate by the 17 most senior members of the Fed System has quite interesting implications. The Fed funds rate is currently ~40 basis points. The median estimate for 2016 is 60 basis points. This means there has to be one more rate hike by the end of the year.

One rate hike would add 25 basis points to Fed funds rate of 37.5 basis points. This brings us to 65 basis points or just above the Fed estimate for the end of 2016 of 60 basis points. The only plausible occasion we see for this rate hike is the Fed meeting in December this year.

The median estimate for 2017 is 1.1%. This means the Fed funds rate will have to tighten by 50 basis points during 2017. This means the Fed members think there will be two increases to the target rate in 2017.

The median estimate for 2018 is 1.9%. This means the Fed Funds rate will have to tighten by 80 basis points in 2018 or three 25bps increases in the target rate in 2018. The Fed median estimate for 2019 is 2.6%, implying three increases in 2019. The longer run estimate rises to 2.9% or one further increase beyond 2019.

Conclusion

The Fed funds rate is currently 37.5 basis points. The median estimate by the Fed for the end of 2016 is 60 basis points. This means that there is a very strong chance of one more rate hike by the end of the year. The only plausible meeting at which that tightening can occur is in December 2016.

Notable catalysts approaching AGM season

	Median				
Variable %	**2016**	**2017**	**2018**	**2019**	**Longer run**
Change in real GDP	1.8	2.0	2.0	1.8	1.8
June projection	2.0	2.0	2.0	N/A	2.0
Unemployment rate	4.8	4.6	4.5	4.6	4.8
June projection	4.7	4.6	4.6	N/A	4.8
PCE inflation	1.3	1.9	2.0	2.0	2.0
June projection	1.4	1.9	2.0	N/A	2.0
Core PCE inflation	1.7	1.8	2.0	2	–
June projection	1.7	1.9	2.0	N/A	–
Memo: Projected appropriate policy path					
Federal funds rate	0.6	1.1	1.9	2.6	2.9
June projection	0.9	1.6	2.4	N/A	3.0

Sources: Board of Governors of the Federal Reserve System

Equity strategy update – watching for catalysts into AGM season

Turning to macro matters

Market focus has again turned to macro matters including fears relating to less accommodative monetary policy in the US and the somewhat bizarre US Presidential race. Such bouts of nervousness, resulting in spikes in volatility, have become the norm in the post-GFC era. We're not under-playing the implications of a medium-term shift in interest rate markets, but believe this will occur gradually. Hence we think that market over-reactions in both directions will offer trading opportunities. Outside of these episodes the market has continued to strongly support quality companies that continue to build their revenue and earnings bases despite the subdued economic environment.

Focus shifts to AGM season

In our Reporting season review we flagged that stocks (on aggregate) looked expensive when measured against delivered earnings and the softer outlook for FY17. We also cautioned against investor complacency during abnormally low volatility in August. An increasing number of corporates this year also chose to defer issuing FY17 earnings guidance until further into the financial year when business conditions become clearer. The AGM season commencing this month therefore shapes as more important than usual in better defining the market outlook.

Using catalysts to assist with market timing

In such choppy and unforgiving markets, correctly identifying stock-specific catalysts to position for or to avoid has become a critical weapon in an investor's arsenal. Below we nominate several positive and negative catalysts as we head into AGM season.

Visit our website to view our Catalysts into AGM season note published 16 September 2016

Notable catalysts approaching

Stock	Comment
Major Banks	The major banks (ex CBA) report their results in late-October and early-November and we think that stable results (similar to CBA's recently) will see them strongly supported for their relative value and yield.
Retailers	We're watching several AGMs for sales/ trading updates. The potential positives are Domino's Pizza (TBA), Baby Bunting (November 21), Bapcor (October 25), Automotive Holdings (November 18), and Michael Hill International (October 7).
Ardent Leisure	The Health Clubs divestment (announced) and Marinas sale (potentially imminent) are set to rejuvenate the balance sheet to fund an accelerated Main Event centre rollout for several years.
Sydney Airport	We think the Institutional investor day on October 17 may be a positive catalyst.
Corporate Travel	We expect a strong trading update at the October 27 AGM and wouldn't be surprised if management said that the company is trading at the top end of its guidance range.
IPH Limited	The market is weighing up further potential acquisitions against the release of a significant amount of stock from escrow on November 19.
Qube Holdings	Financial close on Moorebank is imminent and we expect an update on the outlook at the AGM on November 24.
Macquarie Atlas Roads	The 50% co-investor in Dulles Greenway is undertaking a sale process. We see a likelihood that MQA will buy (requiring a capital raising) or sell under that process. This looks possible in late 2016 or early 2017.
Motor retailers – APE/AHG/MTO	The ASIC review of the provision of Finance and Insurance in car dealerships could weigh on the sector and share prices in the near-term.
Automotive Holdings	The upcoming AGM will be the first time the market hears from the new CEO. Any views on the long-term outlook for Cold Logistics (ie a potential exit) would be well received.
PWR Limited	PWH is attempting to unlock new markets for its products via announcing new material OEM contracts. These could happen at any time.
Bellamy's	Despite increased investment in the business, we expect an upbeat trading update at the AGM on October 19 including evidence that BAL is a beneficiary of Chinese regulatory change.

Volatile pricing belies the stability of infrastructure businesses

It has been a volatile ride for investors in infrastructure stocks over the last quarter. Share prices for most stocks in the sector surged to all-time highs, but were then negatively affected by fears that central banks were considering less accommodative monetary policy settings.

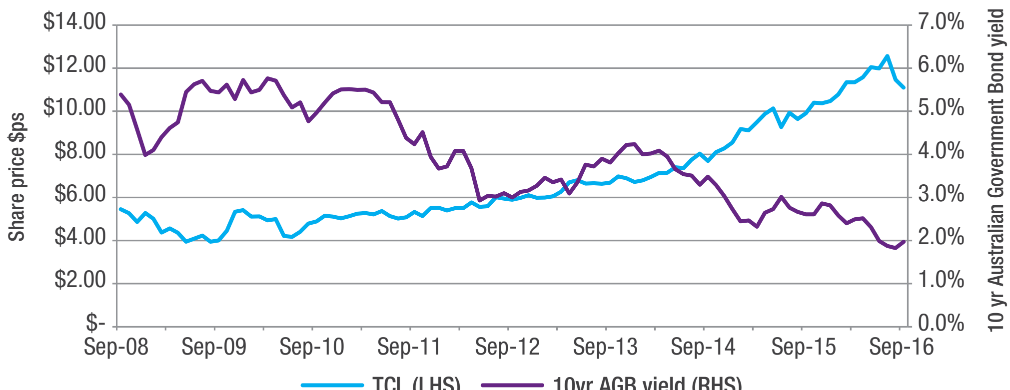
For instance, key big cap stocks APA Group, Sydney Airport and Transurban fell 16-17% from their all-time highs. With the US Federal Reserve choosing not to lift the Fed Funds Rate in September, they have since staged a partial recovery. The net result has been that stocks in the sector generally underperformed the broader market in the September quarter.

Key company specific news in the September quarter included Macquarie Group's partial sale of its stake in Macquarie Atlas Roads, new debt issuance for Transurban, a draft regulatory decision for Ausnet Services, announcement of a new pipeline build by APA Group, and continuing strong passenger growth experienced by Sydney Airport. Pleasingly the August reporting season unearthed no major issues.

For the remainder of 2016 we expect share prices of infrastructure stocks will be influenced by monetary policy considerations, given that investors tend to view the sector as being interest rate-sensitive. Merger and acquisition activity has been a consistent theme for several years, which we expect to continue. For instance, we expect MQA to become involved as either a buyer or seller in the Dulles Greenway as its 50% co-investor seeks to exit the asset. We're watching other key events including AGMs where earnings guidance may be updated, Sydney Airport's investor day in October, and the imminent financial close on Qube's Moorebank project.

With lower share prices, value in the sector has improved. Our preference is for high quality names **Sydney Airport (SYD)**, **Macquarie Atlas Roads (MQA)** and **Transurban (TCL)** in the transport sector and **APA Group (APA)** in the energy sector.

Share prices for key infrastructure stocks are benefiting from abnormally low interest rates



Source: IRESS

REITs and the Fed

The REIT sector has been volatile over the past quarter with macro news the key driver. After expectations that the US Federal Reserve would increase interest rates in September, REITs were one of the worst performers during August along with other defensive sectors. However, as expectations of a US rate rise dissipated around mid-September, the sector staged a recovery. On a 12-month basis, listed property has outperformed with a total return of around 22% versus the broader market at around 13%.

Reporting season was largely in line with expectations with most groups providing FY17 distribution guidance (we outline FY17 forecast distribution yields in the chart below). Outlook statements were generally positive with some leasing challenges remaining (ex Sydney which is strong), although we note many REITs have taken the opportunity to sell some non-core assets over the past 6-12 months given the strong market conditions. Consequently, distribution/earnings growth for some groups may be impacted in the near term (although portfolio quality will likely improve and balance sheets remain sound).

We also highlight the plethora of property IPOs that have come to the market over the past few months. Recent listings include **Australia Office Fund (AOF)**, **Propertylink (PLG)** and **Viva Energy REIT (VVR)**. Another large IPO expected before year end is the **Charter Hall Long WALE REIT**, which is expected to have a market cap of around A$1 billion with a portfolio focused on assets with long weighted average lease expiries.

Our preferred small/mid cap REITs currently include:

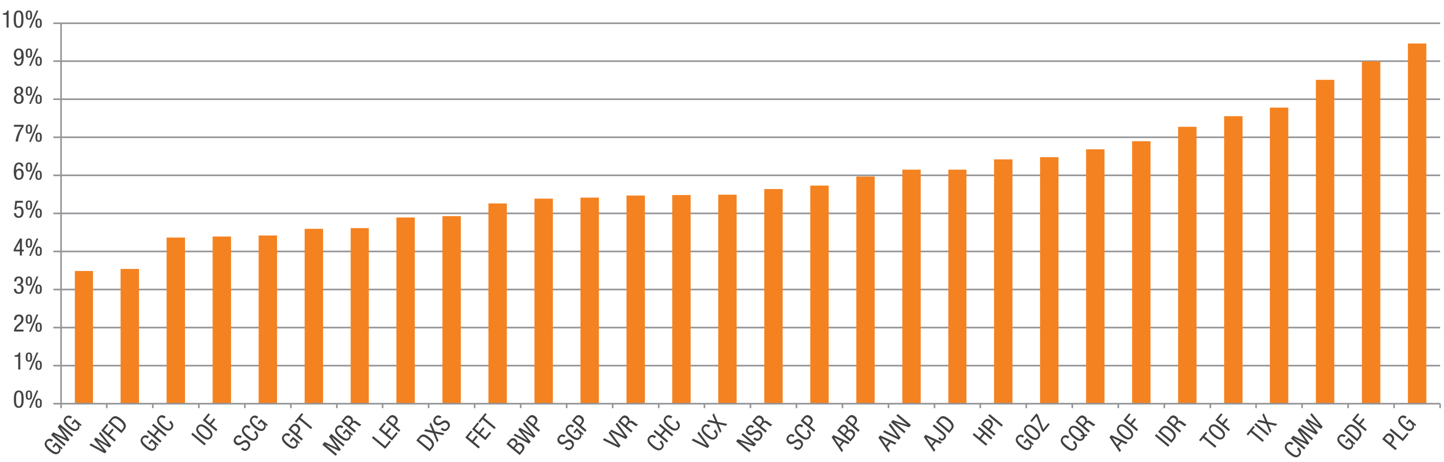
360 Industrial (TIX) – pure Australian industrial REIT with potential ASX 200 inclusion in the medium term and an attractive distribution yield of around 7.8% paid quarterly.

Aventus Retail Fund (AVN) – exposure to large format retail segment (first mover); offers an attractive c6% yield as well as organic/acquisition growth options.

We also like **Asia Pacific Data Centres (AJD)** for a defensive yield (around 6% paid quarterly). AJD owns three data centre assets with triple net leases to listed group NextDC.

Of the large caps, for diversified exposure we prefer **Stockland (SGP)** which offers a sustainable distribution yield. For global diversification, the options remain **Westfield Group (WFD)** which is primarily leveraged to the US (however also has UK exposure so any weakness in the economy there post Brexit may have a negative impact) as well as **Goodman Group (GMG)** which offers exposure to logistics/ industrial assets and distribution growth of 6% in FY17.

Property REITs – FY17 forecast distribution yields



Source: FACTSET

Fixed interest and the Fed

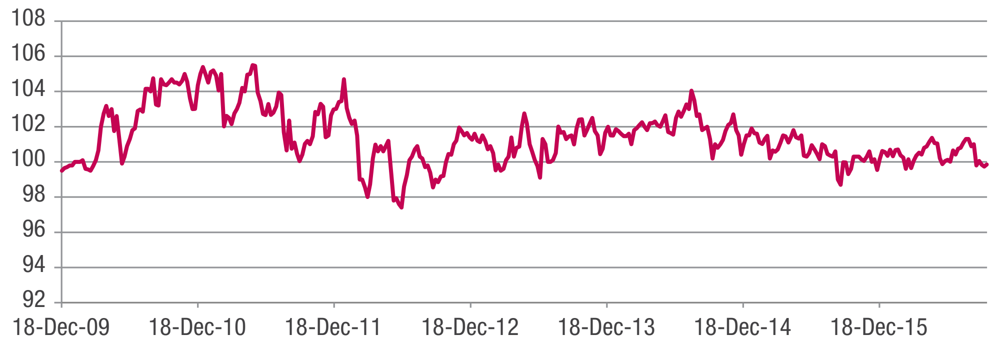
The current low domestic rate environment is expected to remain for some time with the RBA expected to further cut the Official Cash Rate on Melbourne Cup Day. Should this move occur, term deposit rates are likely to decline further putting further pressure on investor incomes. We therefore expect prices of existing ASX listed income securities to remain well supported and would anticipate quality new issuance to be well received by the market.

During the past month we have seen ANZ launch a new Capital Note offering designed to replace ANZPA which has a call date in December 2016. There was strong demand from holders of ANZPA to reinvest their existing holdings in the new offer, and approximately A$900m of the ~A$2bn offer was reinvested. The Capital Notes 4 have a 20 March 2024 call date and pay investors gross distributions based on a margin of 4.70% above the 90-day BBSW. The security commenced trading on 28 September.

We also saw the first vanilla corporate-issued subordinated note launched for a while with Qube Holdings coming to market with a seven-year offering. The security pays investors cash coupons of 3.90% above the 90-day BBSW and we expect the security to perform well once it commences trading on the ASX on 6 October.

Investor demand for ASX listed fixed interest securities remains strong given low cash rates and we continue to expect this to be the case. With ANZPA, ORGHA and WOWHC expected to be redeemed by the respective issuers in November and December of this year, there is likely to be significant capital looking to be reinvested in the sector. Our key picks are **ANZPD**, **GMPPA**, **IANG** and **WBCHA**.

ANZPA Price Performance



Source: IRESS

High Conviction Stocks

Watch our analysts outline key reasons to buy our recently added stocks in short videos available here
www.morgans.com.au/high-conviction-stocks-october-2016

This month's changes

We make three changes to our High Conviction list this month adding Evolution mining (EVN) while removing Megaport (MP1) and BHP Billiton (BHP) following strong share price performance.

Evolution Mining (EVN)

Evolution is a gold mining and exploration company based in Australia. It owns and operates four gold and silver mines in Queensland and Western Australia and is developing a fifth gold-silver-copper project in Queensland.

The mining operation generates strong free cash flow backed by operational diversification from a portfolio of producing long life mines. We see potential upside from the Ernest Henry deal, which has yet to be incorporated into consensus forecasts and recognised by investors. Evolution Mining's average All-In Sustaining Cost (AISC) of A$900-960/oz for FY17 places it very favourably against the current spot price and the global cost curve.

Visit our website to view our recent note Revised three-year guidance published 16 September 2016.

Morgans' High Conviction Stocks

ASX 100

	Ticker	Price	Price Target	Dividend Yield	Gross Yield	PE 12mf (x)	Upside
Orora	ORA	$3.11	$3.25	3.2%	3.5%	20.7	7.9%
Westpac Banking Corp	WBC	$29.92	$31.00	6.3%	8.9%	12.5	12.5%
Healthscope	HSO	$3.09	$3.40	2.7%	2.7%	24.7	12.7%
Sydney Airport	SYD	$7.00	$7.85	4.4%	4.4%	nm	16.5%

Ex-100

	Ticker	Price	Price Target	Dividend Yield	Gross Yield	PE 12mf (x)	Upside
Evolution Mining *	EVN	$2.58	$2.71	1.3%	1.3%	10.5	6.4%
PWR Holdings Limited	PWH	$3.15	$3.26	1.9%	2.7%	23.0	6.4%
Corporate Travel Management	CTD	$17.87	$20.00	1.7%	2.5%	30.2	14.4%
GBST Holdings	GBT	$4.28	$4.95	2.6%	3.8%	17.5	19.4%
Catapult Group International	CAT	$3.45	$4.23	-	-	-	22.6%
Ardent Leisure Group	AAD	$2.80	$3.30	4.5%	4.5%	20.3	22.3%
ImpediMed	IPD	$1.61	$2.13	-	-	-	32.5%
Bellamy's Australia	BAL	$13.08	$16.65	1.5%	2.2%	19.2	29.4%
Kina Securities	KSL	$1.00	$1.47	7.7%	7.7%	8.6	55.0%

Source: FactSet. Data as at 30 September 2016
* New addition

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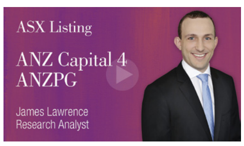

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REGULATORY DISCLOSURES Analyst owns shares in the following mentioned company(ies):
AVN: Morgans Corporate Limited was a Co-Lead Manager to the prospectus offer by Aventus Retail Property Group in September 2015 and received fees in that regard. **WBC**: Morgans Corporate Limited was a Co-Manager to the Westpac Banking Corporation Limited rights issue and received fees in that regard. **PWH**: Morgans Corporate Limited was the lead manager to the public offer of shares in PWR Limited in August 2015 and received fees in that regard. **CAT**: Morgans Corporate Limited was a Lead Manager to the placement for Catapult and received fees in that regard. **IPD**: Morgans Corporate Limited was a participating broker to the placement and SPP offer by Impedimed Limited and received fees in that regard.

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