December 2016

Investment Watch

A strong finish to an eventful year

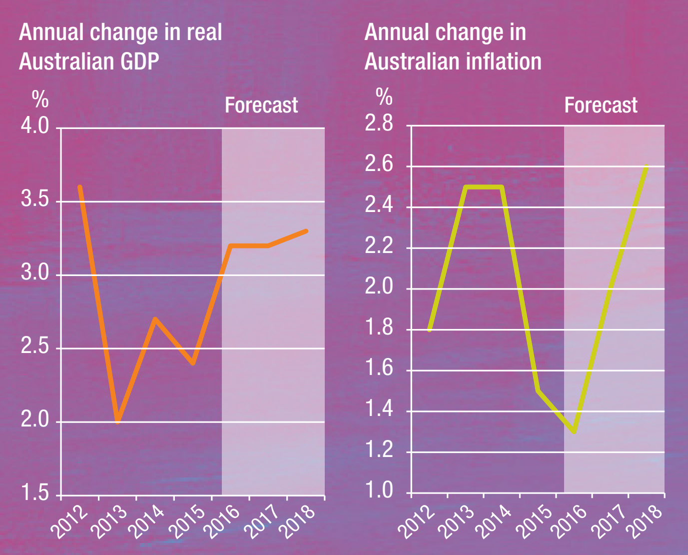
2016 has been a year of surprises. From the political environment to the sporting field, there's been no shortage of outcomes that looked highly improbable at the beginning of the year. Meanwhile, the market has largely shrugged off the macro shocks nearing the end of 2016 at nearly 5% higher.

The weight of cash in search of a reasonable return and an improving outlook for earnings moved investors to increase equity exposure. While it's hard to rule out further volatility, the 'Trump bump' promises to finally break the deflationary effects holding back economic growth. We think that Australian earnings will begin to participate in the increase of US earnings as stronger growth in the US economy feeds into stronger growth in the Australian economy. This should take the Australian equities market to higher levels in calendar 2017. We explore Trump's plans to reinvigorate the US economy on page 2.

While the ASX200 continues its ascent, the difference in performance between sectors and stocks is quite interesting. Rising global interest rates have taken some of the shine off bond-proxies such as Infrastructure, Utilities and REITs, while sectors long in the sin-bin such as Resources and Industrial laggards have attracted some buying. Barring macro shocks, we expect this dynamic to continue to play out in fits and starts as the market gains comfort in the idea of a re-inflationary world. We review our investment strategy and key picks on page 3.

In this issue we look at the implications for sectors leveraged to an upward sloping investment cycle including Retail on page 4, Resources on page 4 and Industrials on page 5.

2016 has been another exciting year of growth for Morgans so from all the staff and management we appreciate your ongoing support as a valued client of our business. We wish you and your family a safe and happy festive season, and we look forward to sharing with you what we believe will be a prosperous 2017.

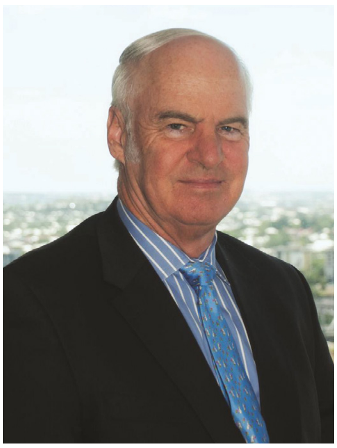


Source: RBA, Morgans

Contents

This edition we look at …

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



Economics – the Trump agenda

Uplift in after tax corporate earnings is the major driver of the much better stock market we have seen since the election of Trump.

In November, markets were startled and then supported by the election of Donald J Trump as President of the United States. The program that Trump intends to introduce is not widely understood. The President's budget for 2018 will enact a comprehensive tax reform plan which will provide a US$4.55 trillion stimulus over the President's four year term.

Trump's Corporate Tax Plan

Donald Trump's economic plan will reduce the corporate tax rate from 35% to 15% and eliminate most tax breaks. The plan will tax carried interest as ordinary income, impose a one-time deemed repatriation tax on profits held abroad, repeal the estate tax and eliminate the corporate and individual alternative minimum tax.

The Trump plan will also: reduce individual tax rates to a simple three tier level of 12%, 25% and 33%. The top level of 33% reduces from the previous top US level of 39.6%. The plan also expands the standard private income tax deduction from US$12,600 per couple to US$30,000 while eliminating personal tax exemptions, and cap the amount of itemised deductions a couple can make to US$200,000.

Trump's plan offers US manufacturers the option of fully expensing, instead of depreciating, their equipment in exchange for giving up the deductibility of interest. Trump also plans to impose a capital gains tax on personal assets beyond US$10 million at the time of death in place of the estate tax.

In addition to enacting comprehensive tax reform, Trump plans to:

- Expand tax breaks for childcare and other caregiving at a cost of US$550 billion;
- Offer partially paid maternity leave through unemployment insurance at a cost of US$50 billion;
- Increase military spending by repealing the Defence Sequester at a cost of US$450 billion;
  - Trump proposes to increase the number active army troops from 475,000 to 540,000;
  - The number of marine battalions from 24 to 36;
  - The number of navy ships from 280 to 350;
  - The number of fighter aircraft to at least 1,200; and
  - To modernise missile defence and cyber security.
- Reduce non-defence spending through a 'penny plan' (this is a 1% efficiency dividend). This reduces spending by US$750 billion.
- Reduce other non-defence spending (reducing overmanning by allowing the natural wastage of public sector employment through retirement). This reduces spending by US$250 billion.
- Spending on school vouchers, improved immigration enforcement and infrastructure spending at a cost of US$20 billion per annum.

The total cost of the Trump program as it now stands is $US4.55 trillion. We estimate this would mean an expansion to the US budget deficit to 4.5% of GDP in 2018. With accumulated debt service, this expands to 4.8% of GDP in 2020.

Economic Impact

Reducing corporate taxes from a headline rate of 35% to a headline rate of 15% notionally increases after tax corporate earnings by 20%. The actual percentage increase can only be determined when we see the President's budget for 2018 early next year. Still, this uplift in after tax corporate earnings is the major driver of the much better stock market we have seen since the election of Trump.

Our outlook for the US economy is that after growing by 2.2% in 2016, growth will accelerate to 2.5% in 2017. This acceleration is in part caused by increased investment in the oil and gas sector which occurs because of the reduction in regulation by Trump of oil and gas exploration. In 2018, growth accelerates further to 2.6%. The Trump budget adds 0.4% to US growth, both in 2018 and 2019.

The Trump budget also expands the US budget deficit to 4.5% of GDP in 2018 and 4.6% of GDP in 2019. The further expansion of the budget deficit in 2019 occurs because of increased debt service. We believe this expansion of the US budget deficit will put downward pressure on the US$ and hence put upward pressure on commodities prices.

Equity strategy update – cyclicals to Trump defensives… albeit slowly

The market in context

The most important event for equity investors in 2016 hasn't been about Brexit or Trump, but about the reversal in the multi-year downward trend in bond yields off their abnormal lows set in early July. This is effectively a market vote of confidence in the outlook for inflation (and growth) based largely on the steady US economic recovery. The surprise election of Donald Trump didn't trigger the bond sell-off, but did accelerate it. Trump's economic agenda offers a plausible route to stronger US, and potentially global growth as Michael Knox has discussed.

The yield party isn't over, but the bubble is deflating

Investors have enjoyed several years of outperformance in high yield and defensive stocks benefiting from their relative appeal to falling risk free rates. Think Property REITs, Utilities and some Industrials. These are now being sold down as the marginal dollar shifts either: a) back into bonds, for their improving returns, or b) into cyclical laggards leveraged to higher economic growth such as commodity stocks and cyclical industrials. Notable industrial performers include difficult-to-forecast cyclicals in chemicals, manufacturing and insurance providing a headache for investors as they offer far less earnings certainty than defensives.

Has the market got ahead of itself?

On our preliminary analysis, Trump's economic plan would add 0.4% to US growth, both in 2018 and 2019 (from 2.4%) which is clearly positive for corporate earnings and share prices. However we think the market's relative moves since the election are overdone, given risks attached to the legislative passage, financing, execution and impact of Trump's plan and the fact that its full effect wouldn't be felt until 2018-19. Our Research Sector specialists can form sensible arguments showing that high yield/defensive stocks are now oversold (too cheap) and that some commodities and cyclicals are overbought (too expensive), as they are similarly discounting risks to a recovery. This isn't the first, nor will be the last time that markets overshoot fundamentals.

Cyclicals to Trump defensives…albeit slowly

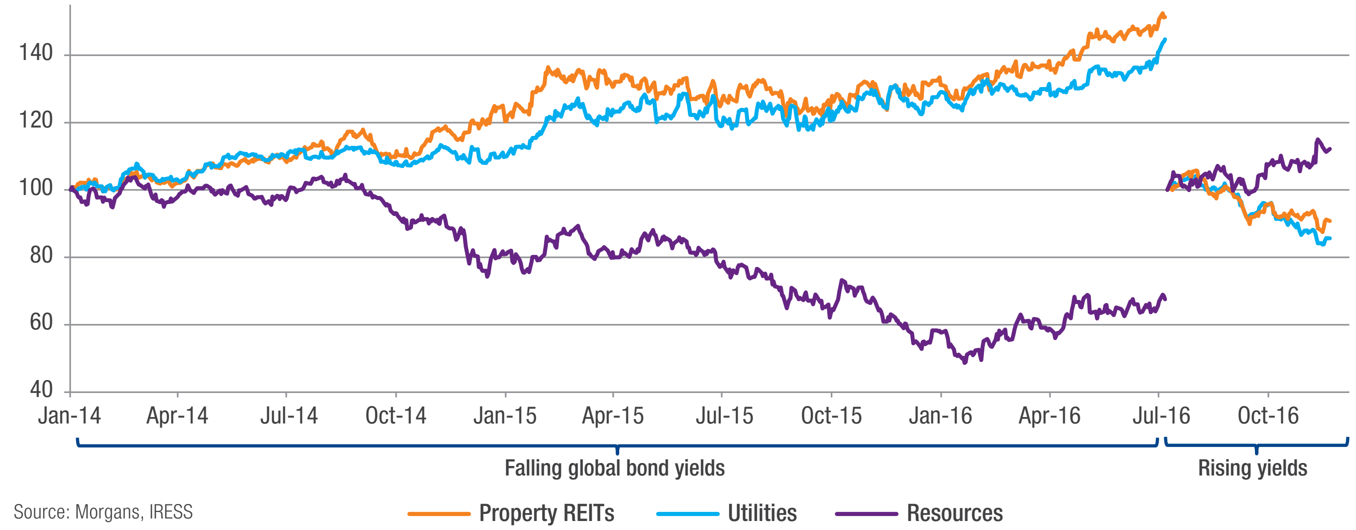
The ongoing recovery of cyclical industrials in line with a reflationary economy is a theme that we expect to continue to play out in coming years. However progress is likely to be slow, and interspersed with periods where the markets may lose or gain confidence in the timing of its trajectory, not to mention likely macro shocks. Similarly, we expect interest rate settings to remain at historically low levels providing investors opportunities to accumulate high yielders which get oversold in the market over-exuberance.

Adapting our Equity Strategy

We have consistently flagged that the path to the normalisation of global monetary policy is going to be slow and bumpy. It's paramount that investors appreciate that after years of debate around the trajectory of interest rates, that the economic environment has now begun to shift. Therefore equity sector allocations that performed best in the last 5 years are unlikely to be those that deliver outperformance in the years ahead. Investors need to adapt with the market.

That said, we aren't overhauling our current Investment Strategy. We advocate a gradual shift in exposure, reallocating slightly less capital to the bond proxies and slightly more to the cyclicals, in line with recent moves in the Equity Model Portfolios over the last few months (accumulating favoured miners, industrials and financials). See also Page 7 for our updated High Conviction lists which contain several names we think can thrive regardless of the prevailing economic environment.

The reversal in relative equity sector performances post the bottoming-out in long bond yields from abnormally low levels in August 2016 is conspicuous



Source: Morgans, IRESS

Retail – in need of some Christmas cheer

Retailers are facing tougher trading conditions than they did in FY16, although pockets of strength are evident. A slow (warmer) start to winter, followed by a slow (cooler) start to Spring has had an impact, particularly on the apparel retailers and inventory positions. This will likely lead to elevated clearance activity ahead of the key Christmas trading period. While this is good for the consumer, it doesn't bode well for listed retailer margins.

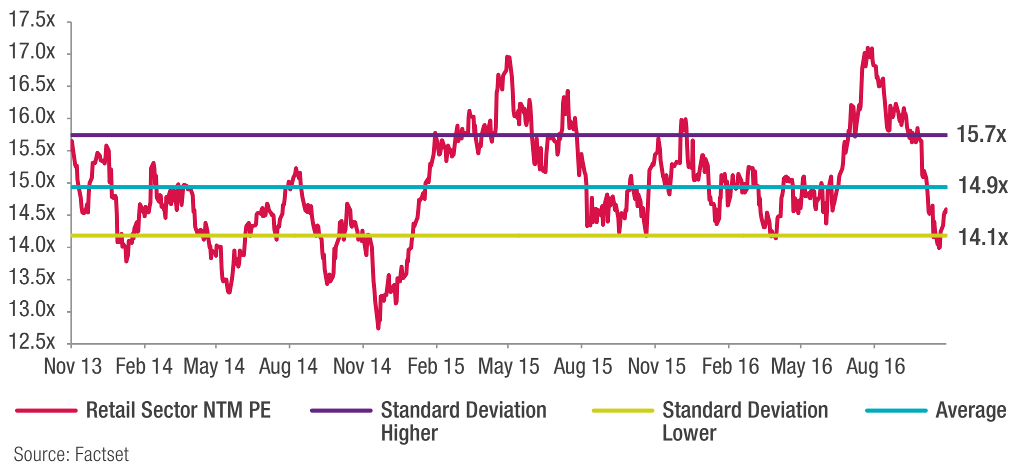
Westpac's measure of Consumer Sentiment shows the Index continues to hold in a very tight band and is trending slightly above the long term average. Responses to Westpac's survey regarding Christmas spending intentions was notably weak, perhaps signalling a relatively benign Christmas spending period.

Retailers have navigated the lower AUD reasonably well, with price increases being implemented across the board, attempting to offset the inflationary impact on their cost of goods sold. We continue to watch the housing market closely for any signs of a real pull-back (we note housing churn has already moderated considerably, as has price growth), but expect reasonably solid conditions will continue for some time yet as the low interest rate environment remains supportive.

Following a strong FY16 period, the average Retail Sector PE was inflated and well above its long-term average. However, the sector has recently de-rated and is now trending slightly below its long-term average. This de-rating has been in response to global market volatility, small/mid-cap volatility, the prospect of Amazon entering the market at some point and the cycling of strong comps in the pcp (including lower petrol prices in the pcp). In relation to Amazon, we expect the group will enter the Australian market (perhaps not until early CY18). The electronics, apparel and sports/outdoors categories are most at risk when Amazon enters the domestic market.

We maintain a cautious sector view on Consumer Discretionary with earnings risk and stretched valuations persisting. Our key picks include: **JB Hi-Fi** (JBH) and **Bapcor** (BAP).

Retail sector valuations – sharp de-rating presents select opportunities



Source: Factset

Resources – the worst is over

While we had expected the commodity price environment to improve in 2016 and that the worst was behind us for resources, we were caught by surprise by the size of economic stimulus rolled out by Beijing this year. This has seen China essentially take a half step back towards investment-led growth in an attempt to avoid a hard landing for its economy as it attempts to shift gears towards a consumption-orientated growth model.

This has triggered an amazing rise in raw material prices in 2016, and supported a broader stabilisation of other metals and energy resources. With the metallurgical coal price having tripled this year and the iron ore price having doubled, the jury is out on how much residual price strength will be maintained once the current tightness eases. Fortunate for the sector, the price strength already posted will deliver substantial increases in earnings all being equal.

Outside of raw materials, commodity prices have generally managed to stabilise during 2016, although some have risen sharply following the US elections, with expectations of a 'Trump bump' to global growth and inflation. We believe a potential transition from monetary to fiscal policy focus is possible and may cultivate a more sustainable supportive environment for commodities (so long as it is successful in stimulating growth), with Trump now standing out as a potential catalyst for the shift in policy gears for the global economy.

While we are now certain that the worst is indeed behind us for the resources sector, the outlook for commodities from here has become more of a case-by-case. While we expect raw materials to decline as Chinese consumption cools, we still remain bullish on the prospects for further increases in base metals (copper, zinc and nickel) and oil.

Unfortunately gold has not benefited from the US elections in the same way that base metals have, with the increased focus on growth causing more of a 'Trump dump' for the yellow metal as investors cut positions to refocus on cyclicals. As a result we have low conviction over the short-term direction for gold, although we do believe the precious metal will strengthen if an inflationary environment emerges in the US or Europe.

With share prices across the sector having posted substantial gains so far in 2016, at this point we believe the best strategy is to remain patient and accumulate positions opportunistically on weakness. Our key sector picks remain **BHP** (BHP), **OilSearch** (OSH) and **Evolution Mining** (EVN).

Industrials – turnaround in progress

Over the last quarter we have seen a significant trend in the market towards more cyclically exposed stocks away from the high growth, high multiple industrials. While there has been volatility in commodity prices, generally speaking they have been trending higher. This has seen some services companies and those stocks with exposure to industrial demand starting to move from their cyclical lows. In our view, investors do need some exposure to cyclical industrials but must be well aware that while stock prices are likely to re-rate on the back of improving sentiment long before earnings can be realised. As such, cyclical names like **ALS Limited** is a good way to gain leverage to improving commodities investment cycle.

Moving to the sluggish Australian economy, we continue to believe that earnings growth for domestically-focused industrial companies is likely to remain subdued. In line with our view over the past 12 months, we continue to see offshore earners as the best place to look for outperformance, particularly those linked to the US economy. Earnings should also be assisted by our weakening outlook for the Australian dollar as Trump begins his tenure as US president in 2017.

Leveraging into an improving US investment cycle

Corporate Travel Management (CTD) is a beneficiary of an improving US economy and businesses travelling more. The US represents about 36% of our FY17 EBITDA forecast and is a key driver of CTD's earnings growth. There is plenty of opportunity for CTD to grow its market share in the US$350bn US corporate travel market. The company's market share currently sits at less than 1% despite the fact that it is one of the top 10 corporate travel companies in the US. We also expect CTD to make more acquisitions in this market. CTD's earnings are also a beneficiary of a falling AUD on translation.

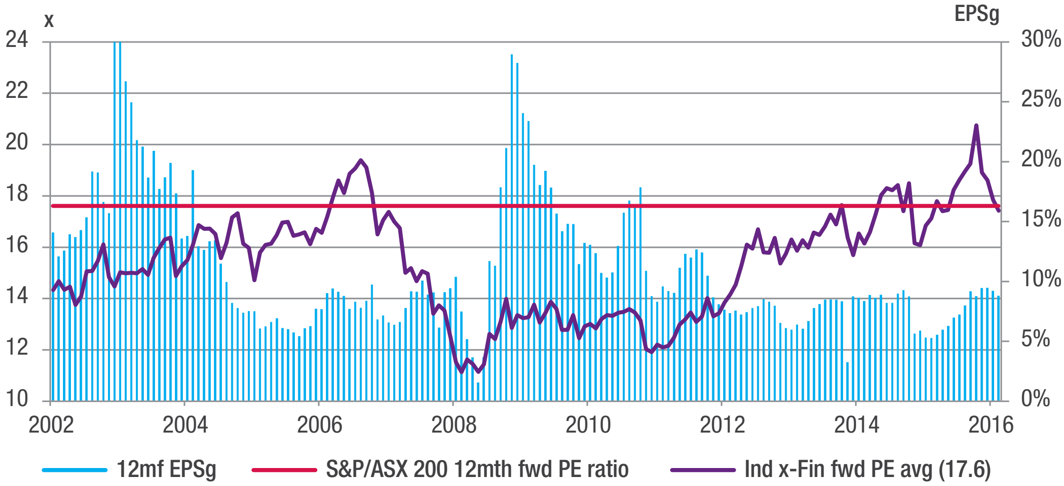
We like companies with defensive qualities given current volatility in global markets. In that respect, **Orora** in the Paper and Packaging sector fits the bill nicely. The defensive nature of its end markets (mostly food and beverage) and strong presence in North America is likely to provide relatively stable earnings growth.

The falling AUD should also provide a nice tailwind and market volatility should see Orora being well supported.

In a similar fashion, USD earners such as **Amcor** and **Brambles** could also benefit. We rate these businesses highly and both are leaders in their respective fields. However, given their global operations with multiple currency exposures, these options are riskier than Orora, but for the astute and patient investor this could not only result in nice diversification to a domestically skewed portfolio but also longer term outperformance.

While we continue to see strong earnings momentum for companies exposed to residential building activity for the next 12 months, we believe company valuations are reflective of this situation. Investors need to tread carefully here. For those seeking exposure to this space, we once again recommend looking at the US. Sticking to our preference for high quality companies it is hard to look past **Reliance Worldwide Corporation**. RWC should have a reasonably long runway of growth as it looks to further penetrate the US plumbing industry via its simple-yet-effective SharkBite push-to-connect fittings.

Industrial (ex-financials) valuations have returned to long-run average



Source: Morgans, Bloomberg

Utilities and infrastructure – down but not out

The share prices of stocks in the infrastructure sector continued to come under pressure during the December quarter (albeit staging a mid-period partial recovery), as the rise in US government bond rates lifted domestic bond rates and thus impacted the valuations. Combined with low domestic CPI, this reversed the 'turbo-charging' of infrastructure stocks from bond rates falling to all-time lows in the middle of 2016.

While share prices may have fallen, the businesses in the sector continue to be robust. Defensive earnings continue to grow, which we expect will deliver solid growth in distributions over coming years (e.g.. TCL's double digit DPS growth target). In fact, revenues of regulated infrastructure will likely benefit as higher risk free rates pass through into higher cost of equity allowances at the next reset. Balance sheets are solid, with investment grade credit ratings. Modern treasury management practices mitigate refinancing and interest rate risk. Debt continues to be refinanced at low long-term rates (in some cases lower than existing cost of debt).

The decline in share prices improves the sector's attractiveness for investors seeking a sustainable yield and growing income. However, we expect share price volatility to continue as and when the expansionary monetary policies of central banks normalise over coming years. As such, we suggest averaging into stocks over time, taking advantage of periods of share price weakness.

In the transport infrastructure space, our preferences remain **Sydney Airport** (international traffic growth) and **Macquarie Atlas Roads** (Dulles Greenway asset sale). **Transurban** is now far more attractively priced (traffic congestion, network optionality). In energy infrastructure, **APA Group** (de-rating of share price captures risks from Vertigan Inquiry underway) and **Spark Infrastructure** (DPS guidance upside from regulatory appeals) are our preferences.

Morgans Annual Conference – Highlights

Security	Description	Price	Price Target	FY17 Yield	Pullback from 12m high
Energy infrastructure					
APA	APA Group	$7.93	$8.52	5.7%	-19%
AST	AusNet Services	$1.48	$1.55	7.2%	-18%
DUE	Duet Group	$2.38	$2.14	7.8%	-13%
SKI	Spark Infrastructure	$2.23	-	-	-16%
Transport infrastructure					
AIA	Auckland International Airport	$5.87	-	-	-24%
AZJ	Aurizon	$5.04	$4.45	5.9%	-11%
MQA	Macq Atlas Roads	$4.60	$5.55	4.3%	-23%
SYD	Sydney Airport	$6.26	$7.85	5.0%	-18%
TCL	Transurban	$10.46	$12.00	5.2%	-17%

Source: IRESS, Morgans, Factset. Data as at 28/11/2016

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-december-2016

This month's changes: We make two changes to our High Conviction list adding ResMed (RMD) and SpeedCast (SDA).

ResMed
Changing lives with every breath

ResMed (RMD)

ResMed is a global company involved in the development, manufacturing and marketing of medical products for the treatment and management of respiratory disorders, with a focus on sleep-disordered breathing. RMD sells a range of products in approximately 100 countries worldwide.

ResMed provides leverage to the growing eHealth and MedTech sector. It benefits from its exposure to the US market and increasing trend in the diagnosis of respiratory disorders.

Refer to our recent 2017 Q1 results note published 4 November 2016 for more.

SpeedCast
Wherever You Are

SpeedCast (SDA)

SpeedCast is a leading global network and satellite communications service provider offering high-quality managed networks services in over 90 countries; and a global maritime network serving customers worldwide.

SpeedCast provides leverage to an improving US business investment cycle and we think it is well positioned for growth post the recent earnings accretive acquisitions.

Refer to our recent note Doubling up published 7 November 2016 for more.

Morgans' High Conviction Stocks

ASX 100

	Ticker	Price	Price Target	Dividend Yield	Gross Yield	PE 12mf (x)	Upside
▸ Westpac Banking Corp	WBC	$31.17	$31.50	5.9%	8.4%	13.0	9.5%
▸ Als Limited	ALQ	$6.50	$7.05	1.9%	1.1%	24.7	9.6%
▸ Orora	ORA	$2.77	$3.25	3.6%	4.0%	18.5	21.2%
▸ ResMed Inc (*)	RMD	$7.91	$9.71	2.4%	3.5%	20.3	26.2%
▸ Sydney Airport	SYD	$6.26	$7.85	5.0%	5.0%	nm	30.4%

Ex-100

	Ticker	Price	Price Target	Dividend Yield	Gross Yield	PE 12mf (x)	Upside
▸ Corporate Travel Management	CTD	$17.67	$20.00	1.7%	2.5%	29.1	15.7%
▸ Catapult Group International	CAT	$3.37	$4.23	-	-	nm	25.5%
▸ GBST Holdings	GBT	$3.84	$4.72	2.9%	4.1%	15.6	27.0%
▸ Evolution Mining	EVN	$1.92	$2.45	1.8%	1.8%	8.7	29.7%
▸ Bellamy's Australia	BAL	$12.20	$16.65	1.6%	2.3%	18.7	38.8%
▸ SpeedCast International (*)	SDA	$3.23	$4.58	2.4%	3.4%	12.5	45.3%
▸ Kina Securities	KSL	$1.04	$1.54	7.5%	7.5%	8.2	56.1%
▸ ImpediMed	IPD	$1.33	$2.08	-	-	nm	56.7%

Source: FactSet Data as at 29 November 2016.
(*) New addition

REGULATORY DISCLOSURES CAT: Morgans Corporate Limited was a participating broker to the placement for Catapult and received fees in this regard. **IPD:** Morgans Corporate Limited was a participating broker to the placement and SPP offer by Impedimed Limited and received fees in this regard. **TCL:** Morgans Corporate Limited was a co-manager to the Transurban Group rights issue and received fees in this regard.

RECOMMENDATION STRUCTURE For a full explanation of the recommendation structure, refer to our website at www.morgans.com.au/research_disclaimer.

RESEARCH TEAM For analyst qualifications and experience, refer to our website at www.morgans.com.au/research-and-markets/our-research-team

STOCKS UNDER COVERAGE For a full list of stocks under coverage, refer to our website at www.morgans.com.au/research-and-markets/company-analysis/ASX100-Companies-under-coverage and www.morgans.com.au/research-and-markets/company-analysis/EX-100-Companies-under-coverage

STOCK SELECTION PROCESS For an overview on the stock selection process, refer to our website at www.morgans.com.au/research-and-markets/company-analysis

If you no longer wish to receive Morgans publications please advise your local Morgans office or write to Morgans, Reply Paid 202, Brisbane QLD 4001 and include your account details.

Queensland

Brisbane Stockbroking, Corporate Advice, Wealth Management	+61 7 3334 4888
Brisbane Edward Street	+61 7 3121 5677
Brisbane Tynan Partners	+61 7 3152 0600
Brisbane North Quay	+61 7 3245 5466
Bundaberg	+61 7 4153 1050
Cairns	+61 7 4222 0555
Caloundra	+61 7 5491 5422
Gladstone	+61 7 4972 8000
Gold Coast	+61 7 5581 5777
Ipswich/Springfield	+61 7 3202 3995
Kedron	+61 7 3350 9000
Mackay	+61 7 4957 3033
Milton	+61 7 3114 8600
Noosa	+61 7 5449 9511
Redcliffe	+61 7 3897 3999
Rockhampton	+61 7 4922 5855
Spring Hill	+61 7 3833 9333
Sunshine Coast	+61 7 5479 2757
Toowoomba	+61 7 4639 1277
Townsville	+61 7 4725 5787

New South Wales

Sydney Stockbroking, Corporate Advice, Wealth Management	+61 2 9043 7900
Armidale	+61 2 6770 3300
Ballina	+61 2 6686 4144
Balmain	+61 2 8755 3333
Bowral	+61 2 4851 5555
Chatswood	+61 2 8116 1700
Coffs Harbour	+61 2 6651 5700
Gosford	+61 2 4325 0884
Hurstville	+61 2 9570 5755
Merimbula	+61 2 6495 2869
Neutral Bay	+61 2 8969 7500
Newcastle	+61 2 4926 4044
Newport	+61 2 9998 4200
Orange	+61 2 6361 9166
Port Macquarie	+61 2 6583 1735
Scone	+61 2 6544 3144
Sydney – Level 7 Currency House	+61 2 8216 5111
Sydney Grosvenor Place	+61 2 8215 5000
Sydney Hunter Street	+61 2 9125 1788
Sydney Reynolds Equities	+61 2 9373 4452
Wollongong	+61 2 4227 3022

Victoria

Melbourne Stockbroking, Corporate Advice, Wealth Management	+61 3 9947 4111
Brighton	+61 3 9519 3555
Camberwell	+61 3 9813 2945
Domain	+61 3 9066 3200
Geelong	+61 3 5222 5128
Richmond	+61 3 9916 4000
South Yarra	+61 3 8762 1400
Southbank	+61 3 9037 9444
Traralgon	+61 3 5176 6055
Warrnambool	+61 3 5559 1500

Australian Capital Territory

Canberra	+61 2 6232 4999

Northern Territory

Darwin	+61 8 8981 9555

Tasmania

Hobart	+61 3 6236 9000

Western Australia

West Perth Stockbroking, Corporate Advice, Wealth Management	+61 8 6160 8700
Perth	+61 8 6462 1999

South Australia

Adelaide	+61 8 8464 5000
Norwood	+61 8 8461 2800

011016

www.morgans.com.au