Stockbroking | Wealth Management | Corporate Advice

Morgans IN ALLIANCE WITH CIMB

Investment Strategy

First Quarter 2017

Economic Outlook

The Trump agenda

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.

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% would reduce from the previous top US level of 39.6%.

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;
- 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 US$4.55 trillion. We estimate this would mean an expansion to the US budget deficit to 4.5% of GDP in 2018.

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 via the reduction in regulation on oil and gas exploration. In 2018, growth is expected to accelerate further to 2.6%. The Trump budget adds 0.4% to US growth, both in 2018 and 2019.

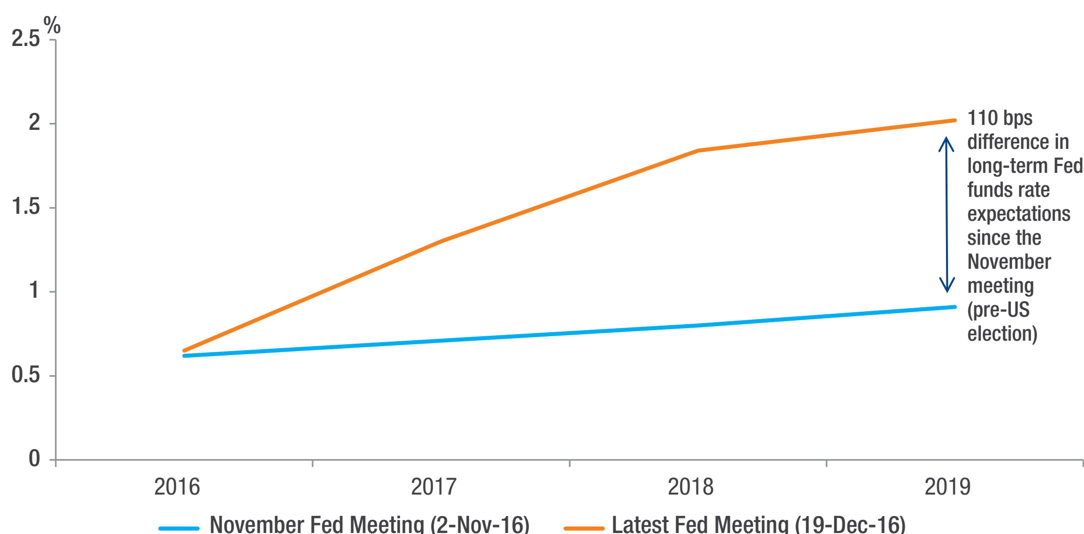
The Trump budget also expands the US budget deficit to 4.5% of GDP in 2018 and 4.6% of GDP in 2019. We believe it will put downward pressure on the US dollar and hence put upward pressure on commodities prices.

Outlook for interest rates

Given the buoyant employment conditions and inflationary impact of Trump's policies, we think there will be at least three further rate increases in 2017. The same will be needed in 2018.

These tax cuts expand the US budget deficit and provides additional stimulus at that time. With the economy at full employment in 2018, the Fed will need to further increase rates to soak up some of that stimulus.

Market expectations for higher US official interest rates



Source: Bloomberg

Rates may begin to normalise very rapidly. We could begin to move to higher rates much more quickly than the market currently thinks.

Outlook for equity markets

US earnings peaked back in the second quarter of 2014 at US$29.60 per share. They then began a precipitous fall. This fall was caused by the slump in oil prices. This decline in earnings took quarterly operating earnings per share all the way down to its final low of US$23.06 per share in the final quarter of 2016. US earnings then began to stabilise. The fall in oil prices which had been so damaging for US earnings, came to an end. As oil prices stabilised, so did earnings.

Our model of the S&P500 tells us that this increase in operating earnings per share takes fair value of the S&P500 up to 2,264 points by the end of the fourth quarter of 2017. A rise in operating earnings per share generates a strong rise in the fair value of the US equities market.

Right now we model fair value of the ASX200 at 5,330 points. This is slightly below the current level of the market. We believe 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.

Watch Chief Economist, **Michael Knox** discuss his thoughts on the Economic Outlook for 2017 with Equity Strategist, **Tom Sartor** at **www.morgans.com.au/strategy2017**

Stronger growth in the US economy should feed into stronger growth in the Australian economy

Australian economic forecasts – end of 2017

	Morgans Forecasts	Market Consensus
GDP Growth	2.7%	2.7%
Inflation	2.0%	2.0%
RBA Cash rate	1.00%	1.25%
Aussie Dollar	0.75	0.73c
ASX200 Index	5,700	5,800pts

Source: Morgans, Bloomberg

Asset Allocation

Asset allocation explained

Strategic Asset Allocation (SAA) is the process of allocating funds between asset classes to optimise investors' return objectives and risk tolerance with long-run capital market expectations. It is perhaps the most important, but one of the most overlooked aspects of wealth management.

The essence of SAA is diversification. Spreading investments across different types of assets can smooth out higher and lower return variations that occur through the economic cycle. This balances long-term return and risk objectives.

The asset classes

The four main asset classes are Equities (shares), Income Assets, Property and Cash. Within Income Assets we include Listed Income Securities (hybrids), Government Bonds, Corporate Bonds and Term Deposits. SAA simply provides a framework for how they should be integrated within portfolios.

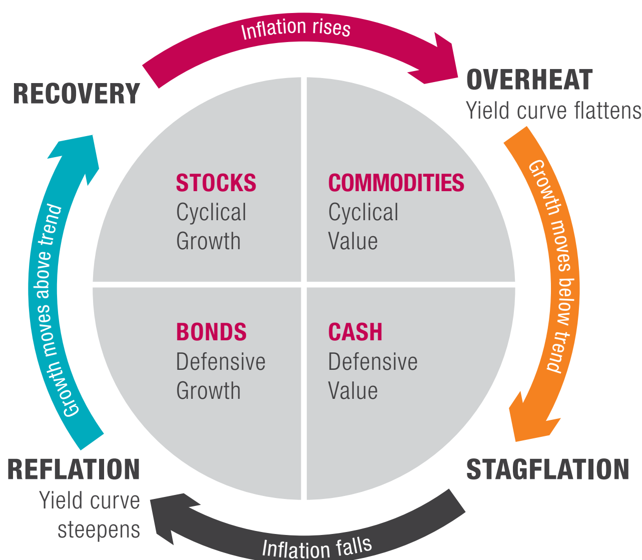
Morgans approach explained

Morgans takes a systematic approach to SAA. We first determine where investing conditions sit within the economic cycle with respect to the relative attractiveness of each asset class. We then apply recommended longer term Benchmark allocations per asset class. Within portfolios, actual allocations have scope to vary by up to 10-15% around Benchmark allocations. These 'Tactical Tilts' represent an investing bias generated by shorter term drivers. Here we take into account:

- the economic cycle
- key forecasts for growth, interest rates and inflation
- risks to these forecasts.

Morgans reviews its SAA settings quarterly in conjunction with Investment Strategy, thus ensuring a stable risk profile.

The economic cycle



Source: Fidelity, Morgans

The economic cycle

We find it useful to reference the global economic cycle when explaining our approach. Fidelity's well known 'Investment Clock' separates the economic cycle into four phases based on the strength of economic growth and inflation. This illustrates the relative attractiveness of various asset classes, which tend to outperform others at various stages of the economic cycle. We use this as a guide only and note that not all phases of each economic cycle are the same.

Recommended asset allocations and active tilts

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. In November, markets were startled and then supported by the election of Donald J Trump as President of the United States, which prompted a re-evaluation of the low-growth/low-inflation thematic that has constrained economic forecasts for the past few years. While we believe that the tide of change is constructive for markets in general, the transition to a reflationary world will be bumpy.

Despite the inevitability of higher interest rates from historically low levels, we still favour a tactical overweight position in Equities but honed towards companies benefiting from an environment of improving economic activity and steepening yield curves such as global cyclical stocks in resources, industrials and financials.

For the Australian share market, the deterioration in company earnings expectations appears to be slowing on the back of stabilising commodity prices. The post-Trump rally has lifted market sentiment and while valuations remain extended we are finally starting to see evidence of a positive pickup in earnings growth. If this trend can be sustained we can expect some further acceleration in the index over the next 6-12 months. However, we do caution investors to not be complacent with exposure and opt for a selective exposure to the Equity market. We maintain our tactical overweight allocation to Equities (4%).

In the context of Trump's intended 'business friendly' policies and deficit funded fiscal program, interest rates are likely to be higher over the next 12 months which will hurt fixed income returns. And the risk that the improvements in the US economy will surprise on the upside may catch the market off guard if official interest rates move higher sooner rather than later. Valuations in property and income assets remain elevated and we see risk that support for the yield trade is likely to fade out in a world of higher interest rates. We increase our underweight exposure to income assets (-5% to -6%) and property (-1% to -4%), and top up our cash position

We adjust our tactical tilts as per below to reflect our preference for Equities (4%) over Income assets (-6%) and Property (-4%).

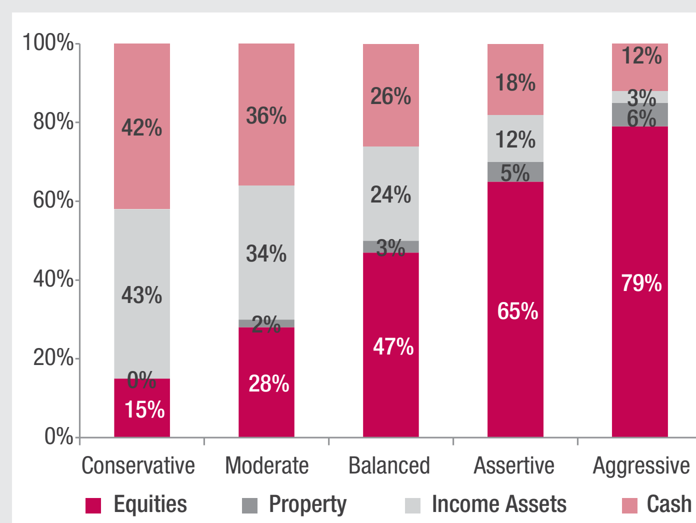
Quick views per asset class

Equities	The deterioration in company earnings expectations appears to be slowing on the back of stabilising commodity prices. We favour cyclical stocks in a backdrop of renewed inflation. Sector and stock exposure will be key to returns in 2017 reflecting the diverging growth prospects across the market.
Listed Property	Low domestic rates remain supportive however premium valuations and property's relative appeal as an asset class will be difficult to sustain in a rising US rate environment.
Listed Fixed Interest	Appetite for ASX listed securities remains strong helped by high issue margins on offer. We continue to recommend clients position portfolios with an average term to call of three years.
Government Bonds	The safety of sovereign debt remains in high demand. With 10-Yr yields below 3%, we prefer term deposits given the government guarantee on amounts up to $250k and the lack of capital price volatility.
Global Infrastructure	Appetite for quality yield will not disappear in a hurry given where interest rates are in relation to long-run averages. The attraction of global defensive infrastructure such as toll roads, airports and utilities remain attractive for income certainty and stable growth.
Term Deposits	Deposit rates have slowed their decline suggesting that banks are competing hard for deposit funding. Deposits continue to be an attractive source of risk-adjusted returns.
Cash	Market expectations are for deposit rates to remain at around current levels through 2017. Despite the low return, we have maintain a higher cash weighting relative to historical levels, to protect against downside risks.

	Conservative	Moderate	Balanced	Assertive	Aggressive	Tactical Tilts
Equities	11%	22%	40%	59%	74%	**4%**
Property	4%	8%	10%	11%	11%	**-4%**
Income Assets	49%	40%	30%	18%	9%	**-6%**
Cash	36%	30%	20%	12%	6%	**6%**

Source: Morningstar, Morgans

Morgans recommended Asset Allocations inclusive of Tactical Tilts



Source: Morningstar, Morgans

Investment Themes

Investing in such an abnormal macro-economic environment is a difficult and potentially hazardous exercise; hence our cautious Asset Allocation settings. Despite the difficult backdrop, thematically driven investing combined with bottom-up stock picking is still delivering solid equity returns for investors as proven by the performance of Morgans' best ideas (High Conviction Lists and Model Portfolios). We detail a dozen market themes in our piece **Key market themes for 2016**, including the best stocks to leverage them.

As bond markets accelerate their correction, we put some context around key market themes which we think warrant investor attention in the coming quarter.

Cyclicals to Trump defensives? Perhaps, albeit slowly

The most important event for equity investors in 2016 has been the reversal in bond yields off highly abnormal lows set in early July and accelerated by Trump's surprise US election victory and promises of improved growth (and inflation). Until then, investors had enjoyed several years of outperformance in high yield and defensive stocks benefiting from their relative appeal versus falling risk free rates.

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 would not be felt until 2018-19.

Morgans sector analysts can form sensible arguments showing that many 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 it be the last time that markets overshoot fundamentals.

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 that we simply cannot predict. Similarly, we expect interest rate settings to remain at historically low levels providing investors opportunities to accumulate high yielders which get oversold in market over-reactions.

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 the economic and interest rate environment has now begun its shift. Therefore equity strategies that performed best in the last 5 years are unlikely to be those that deliver outperformance in the years ahead.

That said, we aren't overhauling our current Investment Strategy but simply advocating 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. Our focus on quality and conviction also aims to recommend stocks which can thrive independently of the interest rate environment (ideally) and/or regardless of political machinations elsewhere. Investors must continually adapt to new realities.

AGM season was better than it probably felt, but beware the landmines

The late 2016 AGM season reminded us of the August reporting season where large cap

Key market themes for 2016	
Avoid complacency to prevent capital loss	Servicing the ageing population
Leverage lower domestic rates for longer	The health & wellness revolution
Profit from a weaker Aussie dollar	Innovation via emerging technology
Diversify Internationally	The digital marketplace
Companies growing offshore	Battery storage
Rise of the emerging market middle class	

Source: Morgans

companies reported stable but generally flat outlook commentary and/or guidance in line with the subdued domestic economy. The major banks reported system growth in home lending and pressure on institutional returns but stable dividends and no major step-up in bad debts. So the market fundamentals of AGM season were probably better than they felt for investors pre-occupied by macro events elsewhere.

EPS upgrades during AGM season outnumbered downgrades by 2:1, however the downgrades were larger and the price reactions brutal. We take some comfort though from the fact that the stocks which downgraded, mostly suffered from individual issues, and not from broader economic headwinds. (e.g. Estia, Ardent, Blackmores, Vocus and Crown). Despite recent weakness, equity market valuations do remain above long term averages, suggesting that avoiding market landmines will again be crucial as we head into the February reporting season.

Using market volatility to your advantage

Renowned investor Peter Lynch famously said that everyone has the brain power to make money in stocks, but not everyone has the stomach. This idea has never felt more fitting than after an unpredictable 2016, however it's important to remember that market volatility is hardly a new phenomenon.

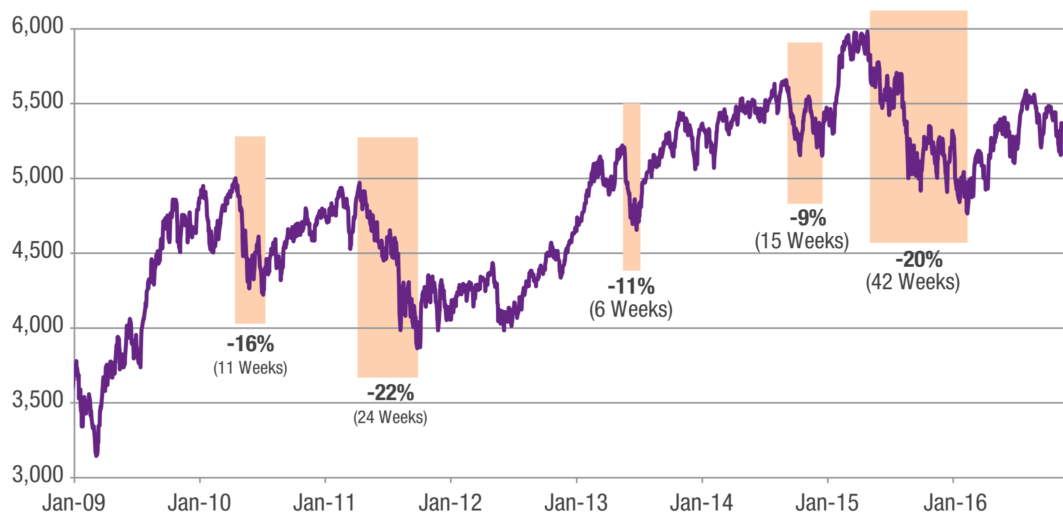
Australian investors have endured several bouts of uncertainty since the GFC, including Brexit (2016), the US Government shutdown (2013) and several versions of the European Debt crisis (from 2010). Unfortunately, the abnormal economic and increasingly unfamiliar political environments are likely to generate more of these events in the coming years. In this context it's important to remember that volatility is normal, and simply a reflection of the price investors pay for the long-term outperformance of shares.

Despite a bumpy 2016, Australian industrial stocks have delivered compound annual returns of 9.1% over the last 20 years, excluding the benefits of franking. We strive to use periods of uncertainty to look through market noise for opportunities to buy high quality stocks during periods where the market thinks it's unfashionable to do so.

Refer to our **Key market themes for 2016** including the best stocks to leverage them.

> AGM Season was better than it felt, but beware potential landmines heading into February results

ASX200: Higher volatility is a reality of the post-GFC investing environment



Source: Morgans, IRESS

Shares

We highlight detailed Analyst views on the drivers of the major equity sectors, their outlook and key stock preferences.

Industrials – backing the US

Over the last quarter we've seen the market begin to pivot away from the high growth, high multiple industrials toward more cyclically exposed stocks. Commodities prices have also been trending higher. Subsequently, some services companies and those exposed to industrial demand have started to recover from their cyclical lows.

We advocate some exposure to cyclical industrials but flag that stock prices are likely to re-rate on these themes before earnings do. For example, **ALS Limited** is a strong second derivative commodities exposure which looks expensive now, but which provides significant front end cyclical leverage.

Earnings growth for domestically focused industrial companies remains subdued and we continue to see those stocks with US derived earnings the best source of outperformance. Earnings should also be assisted by our weakening outlook for the Australian dollar.

Companies with defensive qualities appeal to us in an increasingly uncertain environment. The defensive nature of **Orora's** end markets (mostly food and beverage packaging) and strong presence in North America is likely to provide relatively stable earnings growth, with the falling Australian dollar an additional tailwind. Other US dollar earners **Amcor** and **Brambles** could also benefit. We rate these businesses highly and both are leaders in their respective fields.

Investors need to tread carefully among the housing stocks given our view that we're close to peak cycle valuations. Our favoured exposure is again leveraged to the US. **Reliance Worldwide Corporation** has a reasonably long growth runway as it penetrates the US plumbing industry with its market leading 'SharkBite' product range. **Corporate Travel Management** is also a major beneficiary of an improving US economy as the major source of both organic and acquisition related growth.

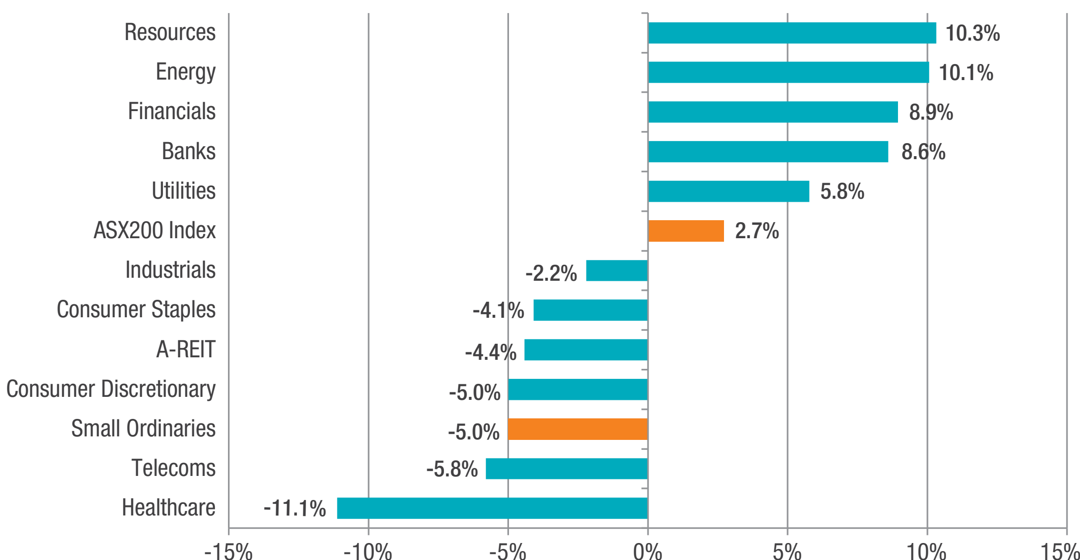
AGM trading updates in the industrials sector were largely in line with expectations with no major surprises. February reporting season will creep up very quickly and given most companies in the sector got the financial year off to a good start it should bode well for earnings expectations. Nonetheless, the environment remains no less tricky than it was 12 months ago and investors need to remain vigilant. As is always the case in such an environment, investors should stick with high quality industrial companies with strong competitive advantages and defendable business models.

Healthcare – a healthy correction

Healthcare stocks continue to underperform the broader market amid the rotation toward cyclicals, although some fundamental issues are apparent. Lower patient numbers through hospitals and radiology practices has put pressure on these sub-sectors. Our industry feedback suggests that modest growth should return, and that stronger fundamentals and solid development pipelines support the potential for above average returns for private hospital operators over the medium term. We prefer **Healthscope** over **Ramsay**.

At the broader level, we think that the Healthcare sell-off looks overdone. Trump does offer a plausible path to fiscally-led reflation, however specifics are scant, debt levels are restrictive and execution risks are material. As such, we see a strong role for Healthcare stocks in balanced portfolios which may consider our preferred names **Healthscope**, **Resmed** and **CSL Limited**.

December Quarter 2016 relative sector performance to date



Source: Iress, Morgans

Telco – fiercely competitive

About 18 months ago we noted that the Telco sector had delivered an average total return of 20% p.a. over the last decade and had substantially outperformed the market in seven out of the last ten years. We flagged that such outperformance was unsustainable, especially in light of high valuations and the likely squeeze that the NBN would put on profit margins. We took a negative view on the sector overall. The penny dropped for the market in August this year with these pressures driving sharp 30-40% corrections in market darlings TPG Telcom and Vocus.

Unfortunately we think the next 12-36 months will remain challenging for the telco operators. The NBN is a once in a lifetime forced churn event and competition is consequently fierce. This is good for consumers but not for Telcos and we advocate investors avoid segments experiencing hot competition. Telstra looks well placed in terms of its market share and compensation for lost earnings. We think Telstra's dividend is sustainable but note the outlook for growth is challenging.

Our preferred sector pick **SpeedCast** is not exposed to the intensively competitive NBN and mobile sectors. The company sells internet connectivity to remote locations, which is a less competitive segment where internet adoption remains relatively immature. US dollar revenue exposure also provides a currency tailwind.

Banks – adapting to new norms

The November full year results for the major banks highlighted their tighter focus on return on equity (ROE), achieved partly via the running off of low-returning institutional exposures. This focus partly results from expectations of further pressure on returns from upcoming reforms to Basel III. However, as 2016 has progressed, the wording coming out of the Basel Committee for Banking Supervision regarding upcoming reforms has become less onerous.

We expect the capital builds for the major banks to be far less onerous than the most bearish forecasters which bodes well for future dividends. ANZ was the only major bank to cut its dividend this year. We expect NAB to cut its dividend next year but we are not expecting WBC and CBA to cut nominal dividends over our forecast period.

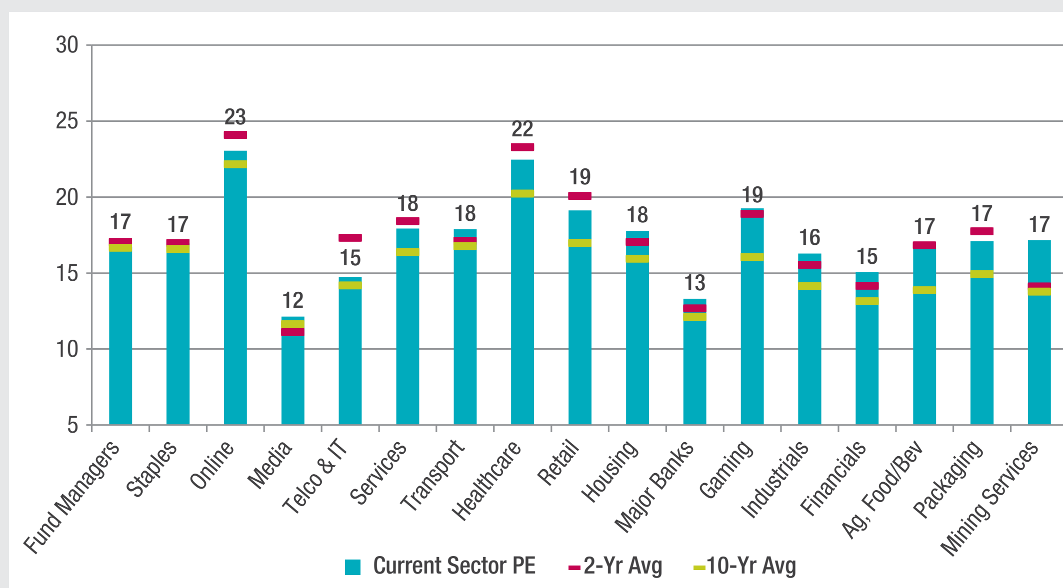
Also on the regulatory front, President-elect Trump has talked about abolishing the Dodd-Frank rule in the US, and this has led some investors to anticipate less onerous bank regulation in the developed world going forward, which has assisted bank share prices generally across the developed world.

Whilst the outlook for ROE and dividends for Australian major banks has improved, we expect bank share prices to experience volatility as the US Federal Reserve attempts to raise the Fed Funds Rate. Increases in the Fed Funds Rate and rising US bond yields are likely to make Australian banks a less attractive option for offshore money in search of yield. We do not expect Australian banks to be affected by this factor, rather we believe there is the risk of capital flight from high-yielding assets generally into US treasuries.

Diversified financials – follow the reflation

The election of Donald Trump has placed a spotlight on potentially inflationary fiscal policies, which has greatest impact for stocks holding large deposit books including insurers QBE Insurance and Computershare. Both stocks are highly leveraged to US bond yield increases and derive

Sector PE multiples: Most sectors are now trading close to their 2 year averages



Source: Iress, Morgans

Shares

~30-45% of revenues from the US meaning they will be beneficiaries of any US corporate tax rate cut. We prefer **Computershare** for its higher earnings certainty achieved via recent acquisitions and cost removal.

Recent insurance events including the New Zealand earthquake will impact Suncorp and IAG. We think that both stocks are still on track to achieve full year guidance, but that upside beyond that has now been removed. The outlook for the health insurers is mixed, with a difficult revenue environment (softer economy, participation / competition) offsetting the benefits of low claims inflation.

While AMP's recent write down for its life business was disappointing, we think that earnings have now finally re-based and now see potential for a special dividend of 10cps post its recent reinsurance program. We believe that Macquarie Group is tracking ahead of consensus for FY17, but its recent result showed that further deals/acquisitions are needed to stimulate growth above underlying revenue weakness.

Resources and energy – a Trump bump

The size of the economic stimulus program announced and enacted by Beijing in early 2016 has driven a surprise surge in commodities this year. China is again using investment-led growth – protecting against a hard landing – to manage what is likely to be a bumpy longer term transition to a consumption led economy.

Coal and iron ore price spikes have dominated market attention. The jury is out on how much residual price strength can be sustained once current tightness eases. Regardless, the price surge will deliver substantial earnings upgrades and de-gearing in the meantime.

Trump's US economic reform agenda has also boosted expectations for global growth and inflation which is positive for commodities, although there are risks to both the execution and timing of its potential impact.

Despite the uncertainties around China and Trump, we are comfortable that the worst of the commodities cycle is behind us. We see scope for a cooling off in price among the bulks (iron ore and coal) but see prospects for further increases in oil and base metals (copper, zinc and nickel).

Rising interest rates on other forms of safe haven investments (like bonds) is a headwind for gold and the short term outlook is uncertain. However if inflationary forces do pick up momentum, or if Trump's promises are replaced by stumbles, then gold is likely to be a preferred safe haven again. Remember that gold is often best bought when no one else thinks that you need to.

After strong 2016 gains, we are accumulators of our favoured exposures on weakness. Our key sector picks remain **BHP Billiton**, **Oil Search**, and **Evolution Mining**.

Consumer staples and retail – tough, with pockets of strength

Retailers are facing tougher trading conditions than they did in FY16, although pockets of strength are evident. A warmer start to winter, following by a 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 Index of Consumer Sentiment is tracking in a tight range slightly above the long term average. Christmas spending intentions are notably weak, perhaps signalling a relatively benign spending season. Retailers have navigated the lower Australian dollar 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 but expect reasonably solid conditions will continue for some time yet, supported by historically low interest rates.

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 and the cycling of strong comps in the pcp (including lower petrol prices). We believe that Amazon will enter the Australian market in 2018 and that the electronics, apparel and sports/outdoors categories will be most at risk when it does.

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

Competition in the domestic supermarkets space continues to step up with Woolworths increasing its re-investment into cheaper prices and improved service. The market initially responded positively to this investment, but the attention is now turning to whether or not this is the start of a positive trend or if the grocery wars will place further downward pressure on earnings.

With growth from the grocery channel now harder to come by and structural issues at play in the discount department store space, we are avoiding investment in either stock at current levels. We believe earnings risk is greater within Woolworths and have a Reduce rating on the stock. We rate Wesfarmers a Hold, maintaining a slight preference for this staple.

Infrastructure – price weakness belies business strength

Infrastructure stocks remained under pressure during the December quarter as the rise in US bond rates lifted domestic bond rates and impacted valuations. Combined with lower domestic inflation, this reversed the 'turbo-charging' of infrastructure stocks after bond rates fell 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. Transurban'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, and in some cases at rates lower than the existing cost of debt.

The correction 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.

Gaming – opportunity out of chaos

It has been a hectic period for gaming stocks with Tabcorp announcing it will acquire Tatts Group via a Scheme of Arrangement. This will take some time to complete but we believe it makes significant strategic sense to merge the wagering operations and leverage Tabcorp's significant experience in this area. The lottery business may however attract corporate interest given the strong returns and free cashflow it generates so a merger between the two companies is not a given. We continue to rate **Tatts Group** highly.

Crown, Sky City and Star Entertainment saw sharp share price declines following the detention of a number of Crown Resorts employees and the potential risks to VIP betting activity. In **Star Entertainment**, we believe this has created an opportunity for investors to purchase a great growth company at an attractive price. We expect the lower Australian dollar to continue driving strong inbound tourism which will benefit SGR's Sydney and Queensland casinos. Furthermore, recent upgrades at The Star and Jupiters will drive customer visitation and spending and we believe the development of the Queen's Wharf project in Brisbane will be a substantial earnings driver for the company over the longer-term.

Online media and IT sector – finding a floor

The online media sector has pulled back sharply in recent months. At its peak the sector traded on 18.9 times one-year-forward cash flow, against today's multiple closer to 14 times. The de-rating is due partly to a global tech sell-off, and to company-specific issues. E.g. A lack of property listings for REA Group and minor problems with the (relatively minor) education business for SEEK.

We believe the online media sector has now found a floor, mostly due to the market now having a good understanding of the profit outlook after adjusting for the operational challenges of FY17. With little apparent further downside risk to earnings, the market should be happy to buy these stocks on significantly lower multiples.

Of the three major online media stocks we believe that REA Group has the greatest near-term potential to rebound. Real estate listings are at 25-year lows and we see potential for a recovery in listings volumes in 2017, especially if interest rates begin rising again. Furthermore the company is trading on the lowest forward multiple in several years.

International

The importance of international diversification

The Australian economy is facing challenging headwinds that have the potential to drag on growth over the medium term. The unwieldy political environment is set to prolong a period of policy inaction, clouding the economic recovery. Couple this with the unwinding of the decade-long mining construction boom and it's likely GDP growth will be stuck in a sub-trend profile for some time.

While pockets of the economy do show genuine signs of growth, we think that having a basket limited to the Australian market exposes investors to suboptimal diversification, risk mitigation and returns over the short-to-medium term.

The key reason why international diversification permits an increase in returns and/or a reduction of risk is because share markets do not move together. This is due to;

- different market compositions;
- the lack of synchronisation of political and economic cycles;
- different institutional structures; and
- different levels of market development

Taking the above into consideration, Morgans' approach to international strategy involves:

Diversification

The Australian market is financials and resources heavy, with these sectors representing almost two-thirds of total market capitalisation. Moreover, SMSF portfolios tend to be heavily concentrated in Australian shares and cash/term deposits (A$160bn, 26%), with the two asset classes making up 58% of SMSF portfolios. Home bias is an obvious concern, with direct equities investments 98% skewed towards domestic stocks. We think this lack of diversification within the Australian equity market poses a risk to domestic investors.

Advancement

We look for leverage in markets that provide superior earnings growth. Current profit growth in the domestic market is forecast by Bloomberg at a modest 7% in FY17 and 5% in FY18 driven by a turnaround in resources. On a relative basis Australia looks to be a laggard across global markets.

Demographics

Demographics is one of the few social sciences where projections can be made with a high level of certainty. If we fast forward 10 years we can estimate the size of the working-age population of most countries (excluding catastrophic events) with far more confidence than predicting the GDP growth rate over the same period.

Morgans' key international themes

Technology revolution and digital disruption	Developing demographics	Rise of the middle class
Digital disruption now has the potential to overturn incumbents and reshape markets faster than perhaps any force in history. Simply put, digital disruption is the effect of digital technologies on a company's current value proposition, and its resulting market position. The difference between digital disruption and traditional competitive dynamics comes down to two main factors: the velocity of change and the high stakes involved. Digital disruptors innovate rapidly, and then use their innovations to gain market share and scale far faster than challengers clinging to predominantly physical business models. Few sectors are immune. Huge opportunities are being won by first movers into disruptive technologies, online and 'e-commerce' penetrating into traditional financial services, retail, advertising and employment markets.	Several developed and emerging nations face demographic challenges as the post WWII baby-boomers grow old. It is the combination of fertility and longevity over the 70s & 80s that pushed the proportion of working age relative to the dependant much higher and created the 'sweet spot' for productivity and growth. What we're seeing now is an inflection point. World population growth is expected to fall from 1.25% now and decline to 0.75% per annum by 2040, according to the UN. As the aging process ramps up, so will the demand for medical services. Health expenditures continue to rise and, given the sharply increasing proportions of the elderly, can be expected to go on rising into the future. The inevitable structural change will give rise to demand for medical and financial services and healthcare products.	In Asia alone, 525 million people already rank in the middle class, more than total population of the EU. Over the next two decades, the middle class is expected to expand by 3 billion. China's population growth rate is quite slow. However, with nearly 1.4 billion people already, even half a percent of growth adds 7 million people – roughly the size of the population of NSW. The end of China's one-child policy could possibly accelerate population growth. Official statistics show China's urban population expanding by 18 million–19 million people per year – closer to the population of the state of New York. Global luxury brands and franchises are best placed to capture this opportunity. In China alone consumers account for 30% of global luxury goods purchases.
Investment Ideas: ▪ Disruptors with proven revenue models ▪ Online mobile businesses (M-commerce) ▪ Cloud providers	**Investment Ideas:** ▪ Financial services ▪ Healthcare providers ▪ Aged-care operators	**Investment Ideas:** ▪ Middle-upper class global franchises ▪ Financial services ▪ Online retailing and M-commerce

Property

Commonwealth Government 10-year bond yields have bounced around 100 basis points off the all-time lows reached in mid-2016. We expect this is in anticipation of the US Fed likely raising rates in December 2016. We note that bond yields are currently at levels last seen in late 2015. We expect the Trump win in the recent US election is likely to speed up the increase in US rates over the medium term which is driving bond yields higher. Trump's policies certainly are potentially supportive of better US and global growth, which the bond markets have been quick to price in.

As a result of the macro environment, the REIT sector has underperformed the broader market over the past quarter. Whilst the decline in security prices has improved the sector's yield (average yield currently around 6%). We also note the premium to NTA gap has narrowed to around 20%. Looking at fundamentals, we note that balance sheets remain solid with gearing levels averaging around 30% for most groups. We expect M&A is likely to increase near term within the sector, with direct property acquisitions still challenging given pricing.

Our preferred yield plays include:

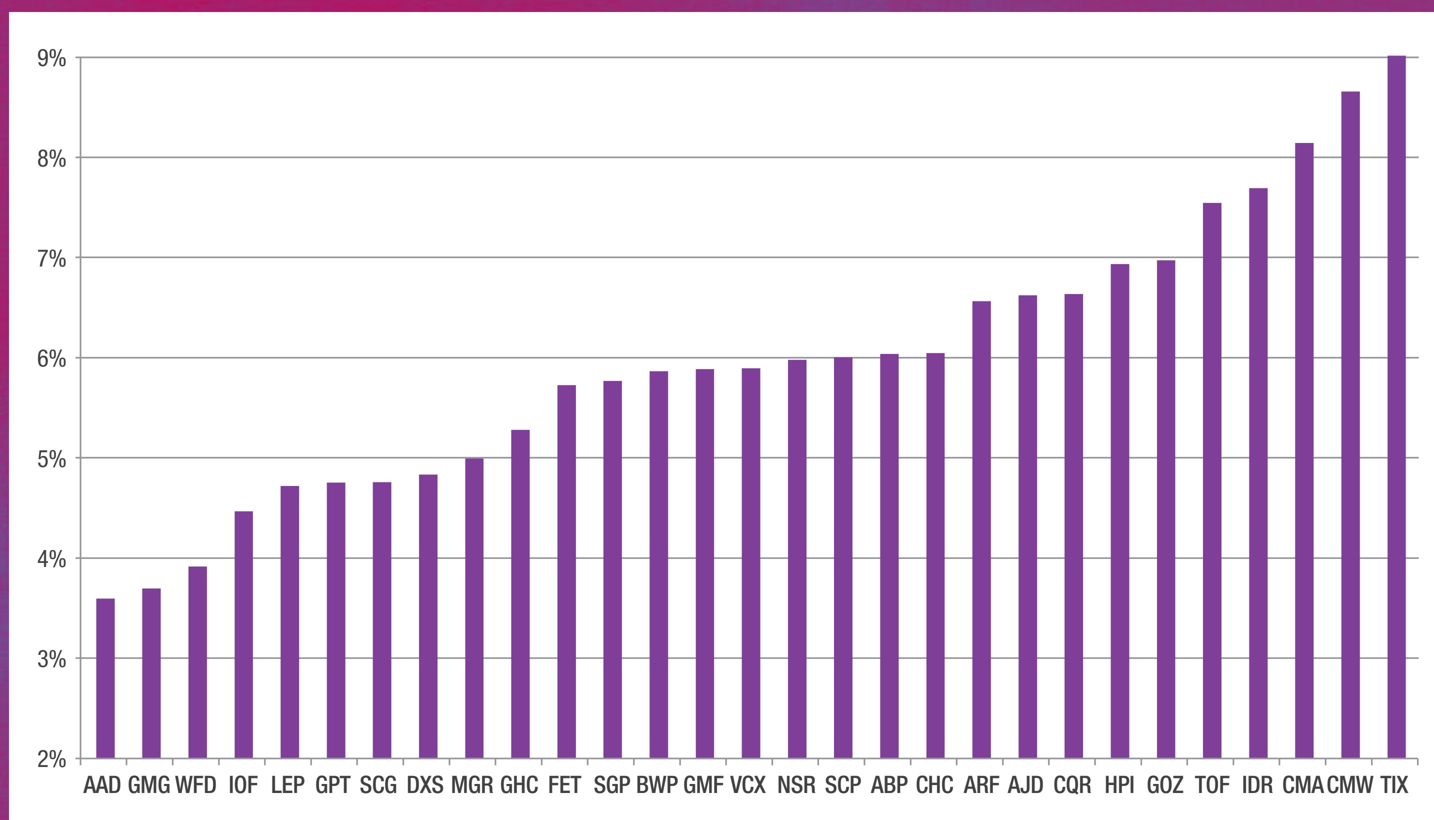
Viva Energy REIT with distributions underpinned by fixed 3% rental increases until 2025.

Cromwell Property Group attractive 9% distribution paid quarterly. While there are near term challenges on leasing, we expect an outcome on its IOF stake could be a potential positive catalyst near term as this would reduce gearing levels.

360 Capital Industrial Fund has an attractive yield +8% paid quarterly. Near term news flow likely to be around asset sales which would reduce gearing. The group is currently undergoing a change in management to Centuria Capital, however they have stated there will be no change in strategy for the group.

Aventus Retail Property Fund offering a yield of +7%, with good organic growth available within the existing portfolio, as well as opportunities in a highly fragmented market.

ASX Property REITs: Consensus FY17 Yields



Source: Factset, Morgans

Income

Fixed Interest

There has been plenty going on in the fixed interest space of late, with Australian Government bond yields surging on expectations of higher rates in the US following the recent Presidential Election. Investors are reassessing their expectations for the RBA cash rate and inflation, resulting in 10 year yields jumping from 1.9% in September to 2.8% currently! This move has seen bond prices decline sharply and investors have suffered significant mark-to-market losses. We have been cautious on government bonds for some time and recommended retail investors instead position in term deposits given the risk around bond prices.

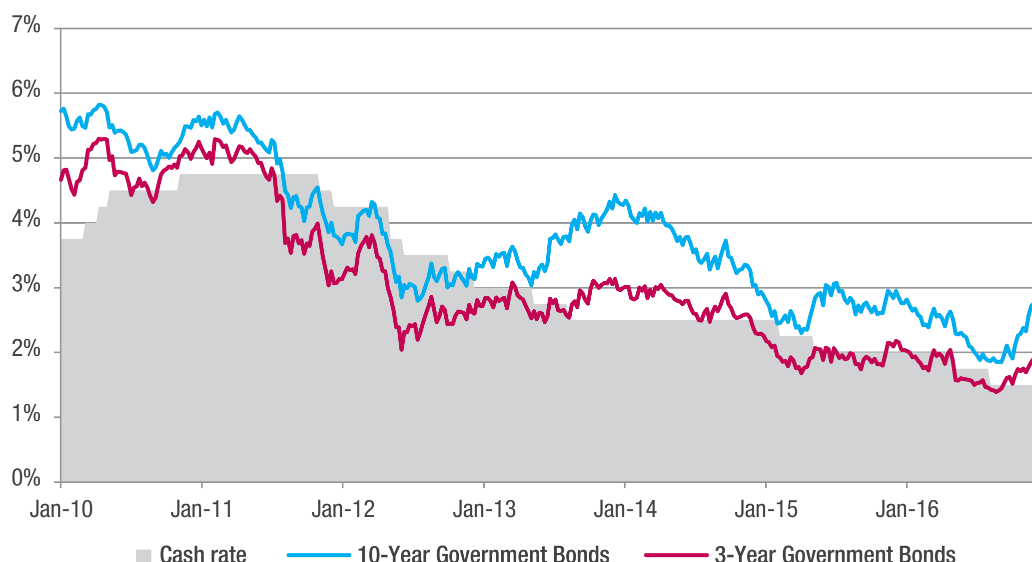
In the listed fixed interest space investors continue to chase running yield at the expense of the total return offered by a security. We view this as a risky strategy and one which is driven by low term deposit rates currently on offer. Investors are looking for yield (a theme which we have seen push prices on high yielding equities up) but a focus for fixed income investors needs to be on the yield to call (YTC), not just the running yield as the YTC factors in capital movements as well.

There has been some significant activity toward the latter part of this year in some of our favourite names with ANZPA, ORGHA and WOWHC all being redeemed for cash in the final quarter of 2016. We expect to see a large proportion of these funds re-enter the market and suggest investors look to buy CTXHA, IANG, GMPPA, QUBHA, TTSHA and WBCPC.

We expect another big year of issuance in 2017 as financials continue to build regulatory capital and corporate issues seek to extend debt maturities and lock in funding for an extended period.

We expect another big year of fixed interest security issuance in 2017

Australian Government bond yields versus the RBA cash rate



Source: IRESS, Morgans

Best Ideas

Investment Strategy has stepped through our top-down macro-economic views (Pages 2-3) and how these shape our Asset Allocation settings inclusive of Tactical Tilts (Pages 4-5). We have detailed our current views on each of the Equities, Property and Fixed Income asset classes, including a closer look at the outlook for each of the Equity sub-sectors and our preferred stocks in each sector. Below we summarise our best current ideas which are updated via our monthly publications.

The Morgans Research team maintains **High Conviction Stock** lists detailing our best large cap and small cap Buy ideas over a 12-month timeframe. We also maintain an **Active Opportunities** stock list which highlights higher conviction trading ideas over a shorter timeframe, usually supported by a tangible catalyst. These lists have consistently generated positive returns since inception on 2012.

View our latest monthly **High Conviction Stock list** online and verify our performance.

The Morgans Investment Committee actively manages a series of **Model Portfolios** for use as guides for various investing styles across the Equity, Listed Property and Fixed Interest asset classes. Investors may use these Portfolios individually or within the Morgans Asset Allocation framework. We are pleased to report that all three equity portfolios (Income, Balanced and Growth) have outperformed the market over the medium term.

View our latest monthly **Model Portfolio Report** online.

We encourage clients to contact their adviser or visit **www.morgans.com.au** for more details.

Equities: Preferred stocks by sector	
Banks	Westpac
Financials	Computershare
Industrials	Orora, Corporate Travel, ALS Limited
Healthcare	Healthscope, Resmed, CSL
Telecommunications	Speedcast, NextDC
Resources	BHP Billiton, Oil Search, Evolution Mining
Consumer Staples	Wesfarmers
Consumer Discretionary	JB Hi Fi, Bapcor
Food & Agriculture	Nufarm, Elders
Infrastructure	Sydney Airport, Macquarie Atlas Roads
Online services	GBST

Property: Preferred AREITs	
AREIT's	360 Capital Industrial Fund, Aventus

Fixed Interest: Preferred securities	
Hybrid securities	CTXHA, ANZPG, IANG, GMPPA, WBCPC

Source: Morgans

High Conviction large caps	Price (A$ps)	Target (A$ps)	Capital Upside	FY17 Yield
Sydney Airports	6.43	7.85	22%	5.2%
Orora	2.81	3.25	16%	3.7%
Westpac	32.30	31.50	-2%	5.9%
Healthscope	2.29	2.90	27%	3.3%
ALS Limited	6.08	7.08	17%	2.0%

High Conviction mid-small caps	Price (A$ps)	Target (A$ps)	Capital Upside	FY17 Yield
Speedcast	3.16	4.58	45%	2.7%
Evolution Mining	1.82	2.45	34%	2.4%
Corporate Travel	16.82	20.00	19%	1.9%
GBST	3.81	4.72	24%	3.0%
Catapult	2.68	4.32	61%	0.0%
Impedimed	0.98	2.08	113%	0.0%
Kina Securities	1.10	1.49	35%	8.1%

Source: Morgans (Priced at 14 December 2016)

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