February 2017

Investment Watch

Entering a new phase for markets

2017 presents new opportunities for investors, with equity markets buoyed by renewed expectations for growth. The ASX 200 ended the year up 11.8% (including dividends) and FY17 promises to be the first time in two years where both earnings and revenue growth turns positive.

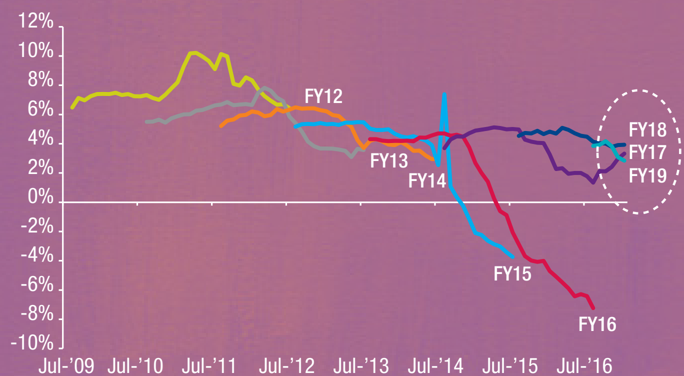
Ahead of the February reporting season we remind investors to take stock of portfolios. The key investment themes that defined the last three years are unlikely to define 2017. Until Q4 2016, investors bought equities for yield and bonds for capital gains. We shift away from 'lower-for-longer' trades and enter 2017 with the view that we are entering a new phase in markets, which is less to do with central bank (in)action and more to do with fiscal stimulus and reflating global growth.

We see 2017 as a transitional year, with the anticipated US policies to reflate the economy to flow on to global growth and commodity prices, which bodes well for most sectors of the Australian economy.

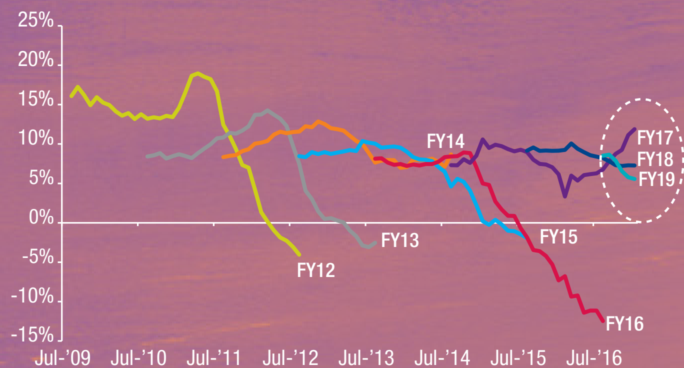
Attention turns from global factors to the domestic results season. Investors have had a lot to consider recently and we think outlook comments may be as important as numbers this reporting season. We do think this highly anticipated reporting season will provide an opportunity to assess the true picture of earnings and whether we are nearing a cyclical turning point.

This month we explore the themes that we think will define reporting season and highlight the stocks that could potentially beat or miss consensus expectations on page 3. Following the inauguration, we explore President Trump's agenda for trade and the implications for Australia on page 2. Q4 2016 was an exciting time for the Morgans network as we participated in a number of outstanding IPOs we provide a snapshot of the companies on page 5.

ASX200 sales growth



ASX200 EPS growth



Source: Morgans, FactSet

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Contents

This edition we look at ...

Entering a new phase for markets 1

Economics – President Trump's trade agenda 2

Equity strategy – a highly anticipated reporting season 3-4

Highlighting recent initiations 5

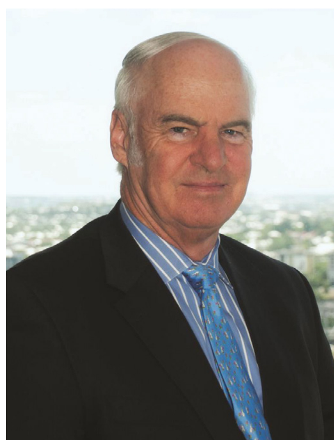
Healthcare – dissecting the sector 5

Fixed interest – taking profits 6

Insurance and diversified financials – reporting season preview 6

High Conviction Stocks 7

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



Economics – President Trump's trade agenda

In the long history of US presidents, there are only three that have economics degrees. It is generally a surprise to most people that Donald J Trump is one of those people. The other two were also Republican presidents. These were Ronald Reagan and Gerald Ford.

Trump probably has the degree from the highest rated school of the three. He graduated from the Wharton School of the University of Pennsylvania. Ronald Reagan graduated from Eureka College in Illinois and Gerald Ford graduated from the University of Michigan.

Last year, I had dinner with a long term secretary/treasurer of the American Economics Association and asked him if he knew how Trump went in his degree. He replied that Trump's problem was that at the age of 21 when he was studying economics, he was also building a hotel at the time. He noted that whereas Trump's teachers had an only average opinion of his academic performance, my esteemed colleague had a very high opinion of the hotel.

In a recent meeting with US union leaders on 22 January, Trump noted that he had just signed an order putting an end to US involvement in the Trans Pacific Partnership (TPP). The union leaders responded to his announcement with a hearty cheer. What Trump went on to say was perhaps more interesting.

Trump then began a quite specific commentary of the problems of enforcing multilateral trade agreements such as the TPP. He noted that once the US had entered into these agreements, it was very difficult to enforce the terms of these agreements. Trump then argued that it was much better for the US to enter into a series of bilateral trade agreements. These were done directly with the other country involved and could be negotiated with enforceable provisions.

Speaking in terms that the union leaders might understand, he said 'If the other side does not keep to the terms of the bargain, then in 90 days they are fired'.

In an earlier time, I was an Australian Trade Commissioner. I spent time in both commodity policy and in international trade policy, as well as in other areas. I remember being told by my first assistant secretary that trade policy went in cycles. These cycles were from multinational trade agreements, to bilateral trade agreements. The cycle he said went from bilateral to multilateral and then back to bilateral. It appears that we are moving back into a period of bilateral trade policy.

It turns out Australia is really good at both. At the same time, as we are participating in the negotiation on the TPP, a multilateral trade agreement, we also completed a free trade agreement with China, a bilateral trade agreement. Prior to this, we had also negotiated a free trade agreement with the US, another bilateral trade agreement. India has asked to rapidly negotiate a free trade agreement with Australia. When this is completed, this will be another bilateral trade agreement.

Opportunities under NAFTA

Trump is famously dissatisfied with a multilateral trade agreement that the US has with Canada and Mexico called the North American Free Trade Agreement or NAFTA. He says that he wants to re-negotiate it. In fact, a little known provision of NAFTA already allows him to apply significant force. The original NAFTA agreement included a provision for annual review. This allows the US to modify the operation of the agreement if it feels that operation is not satisfactory. This provision for annual review has **never** been exercised. I suspect that this provision will now be excised by Donald Trump.

> It was much better for the US to enter into a series of bilateral trade agreements that could be negotiated with enforceable provisions.

In doing so, Trump will put pressure on both Canada and Mexico. Both of these countries are like Australia signatories to the TPP. I think that the pressure Trump puts on Canada and Mexico under NAFTA will make both of these countries much keener to ratify their membership of the TPP so they can take opportunities to trade with other members in the western Pacific. This is also another reason Australia should ratify the TPP.

Improving the US Free Trade Agreement

Trump has signalled that he wants to increase the size of the US navy by 78 ships. He also wants to increase the number of marine battalions to 36 (four marine divisions). This is the highest number of marine divisions since the Vietnam war. The purpose of increasing this naval power is to exert that power in the western Pacific. The major US rival in the western Pacific is China.

If Trump wishes to do this, then Australia, because of its location, will become an increasingly important strategic ally. Trump has signalled that he wants to rapidly negotiate a free trade agreement with the UK because of its strategic position. It may be even more important for Trump to negotiate a free trade agreement with Australia because of our strategic location.

Trump's decision to favour bilateral free trade agreements, rather than multilateral agreements could wind up favouring allies in important strategic locations. One of those allies in important strategic locations is Australia.

Equity strategy – a highly anticipated reporting season

Ending the earnings drought

1H reporting season kicks off in earnest in February and according to the latest Factset consensus earnings estimates, EPS growth for the S&P/ASX200 is forecast at 11.9% in FY17, up from 6.3% at the end of FY16 reporting season. Pleasingly this would still mark the end of the earnings recession after two straight years of contraction although primarily led by the rebound in the resources sector.

Management cues may be more important than numbers

Key themes are likely to revolve around commodity prices, housing, interest rates and FX. Corporate commentary is expected to take on increased importance given the extent to which US reflationary expectations have driven the market against a weak economic backdrop domestically. Historically high payout ratios amid a burgeoning cyclical recovery will mean the balance between capital spending and return plans will be a key area of focus.

Being rewarded for not expecting much

The diminishing risk of global deflation has prompted a revaluation of the outlook for growth among investors. Against an expensive market (>16x 12-month forward PE), the prospects for improved pricing power and demand have increased the appeal for the overlooked ‘value’ segment of the market (low price-to-earnings and price-to-book). We think that ‘value’ (stocks with low expectations) has a higher propensity to surprise and therefore attract buyers this reporting season, while expensive stocks will be punished if elevated expectations are missed - Brambles’ recent downgrade is a timely reminder against complacency.

Resources revival – cash flow and capital management in focus

With miners having focused on cost reduction and balance sheet repair for some time, we think the decisions about how they choose to re-allocate the proceeds of windfall FY17 cash flows will be insightful. Company insights into the longevity of the current cycle/ recovery will be key in February. If the miners start to reallocate meaningful capital toward exploration, expansion capital or possibly M&A, then we would expect the market’s faith in the commodity recovery to also build. See other themes to watch below.

Theme	Comment	Stocks/sectors to watch
Tepid revenue / EPS growth (Industrials)	Revenue and EPS growth have eroded over the last several years down to low single digits. However improving inflation prospects may be the positive catalyst needed for the start of an earnings upgrade cycle.	Telstra, Staples, Industrials services
Corporate outlook & guidance	Corporate outlook statements and guidance have become progressively less-committal in recent periods. Tepid revenue growth, combined with fresh political uncertainties (UK/Europe, US) will arguably see this trend continue. Conversely, companies that are able to issue definitive guidance should be well supported.	Dominos, Beacon Lighting, Corporate Travel, SpeedCast
How much more cost out?	Cost removal is likely to remain a key source of EPS growth although the theme is maturing. The market expects gross margins to expand in FY17 despite having trended flat over the last few reporting periods. We question how much more cost can be removed and the ramifications for growth when the cycle turns.	Industrials, Resources, Packaging
Earnings quality and balance sheet repair	Leverage in the industrials sector remains low compared to pre-GFC levels, which has improved the quality of earnings generated. The Infrastructure and REITs sectors have historically been more leveraged but have reduced or maintained leverage over this period of low interest rates.	Infrastructure, Utilities, REITs

Equity strategy cont...

Theme	Comment	Stocks/sectors to watch
Capex cuts	Corporates have been shoring up free cash flow by cutting growth capex (miners, QUB), although the WOW experience shows how this can bite companies in highly competitive industries. Years of cost-out will hurt operating leverage when the business cycle eventually does turn which appears closer than it has for some time. We think the market will strongly support growth (capex) into the right opportunities.	Resources, Packaging
Retail momentum at risk?	Out-of-cycle interest rate increases and commentary pointing to a mixed Christmas within the sector will increase the probability for more surprising/ disappointing results than normal. Masters clearance activity is expected to impact housing related retailers (Wesfarmers, BLX, Super Retail Group).	JB Hi-Fi, Myer, Beacon Lighting
Downgrades punished	With the market trading on 16.0x, there very little margin for error among growth stocks. High PE stocks which downgraded into August like Blackmores, APN Outdoor and BWX were not taken well by the market. Stocks with negative earnings momentum into the result trading at elevated PE are most at risk.	Carsales, REA and Packaging
Releasing cash via buybacks / specials?	Cashed up balance sheets and cheap funding costs have left buybacks and specials on the table at upcoming results.	AMP, RIO, BHP
East coast housing	East coast housing momentum continues with house prices up double-digits in Sydney (13%) and Melbourne (11%) for 2016. Although approvals looked to have peaked, activity levels may remain elevated for some time.	Boral, Lend Lease, Stockland
Turnaround stories	With high growth stocks expensively priced, stocks that have demonstrated earnings recoveries via recent results have been strongly rewarded off relatively lower bases. (e.g. Cleanaway, Bluescope and Treasury Wines).	Super Retail Group, AMP, Resources

Reporting season potential hits and misses

Catalyst	Stocks
Potential beats	Motorcycle Holdings, JB Hi-Fi, Bapcor, Corporate Travel, Webjet, Inghams, Volpara and Credit Corp
Likely to see positive outlook statements	Beacon, Super Retail Group and SpeedCast
Potential for positive capital management	AMP, BHP and Rio Tinto
Potential misses	Automotive Holdings, Adairs, Ardent Leisure, Computershare, Virtus, Flight Centre, Star Entertainment Group, TPG, Vocus and ERM Power
Vulnerable high PE stocks	REA and Carsales

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Highlighting recent initiations

Q4 2016 was an exciting time for the Morgans network as we participated in a number of outstanding IPOs. Comprehensive research reports can be obtained through the Morgans Website, alternatively speak to your adviser. We summarise a few of the recent initiations below.

Apollo Tourism & Leisure Ltd (ATL) is a multi-national manufacturer, rental fleet operator, wholesaler and retailer of a broad range of recreational vehicles (RVs) across Australia, New Zealand, the USA and Canada. ATL has grown over the last 30 years from a family-owned business to operating 24 centrally located RV rental offices across four countries. Its portfolio of well-known brands allows the group to cater to all travellers' budgets and leverage one of the largest fleets in the world towards both domestic and international tourists.

Ingham's (ING) is the largest vertically integrated poultry producer across Australia and New Zealand, holding #1 and #2 market positions by value, respectively. ING is the market leader of a domestic poultry growth story in an industry where there are clear barriers to entry, and its scale gives it bargaining power with customers. We anticipate continued demand for poultry driven by consumer preference for healthier (leaner) white meat and poultry is the cheapest and most versatile protein. Chicken products are two of the top five fresh products sold in Australian supermarkets.

Midway (MWY) is Australia's largest producer of woodchips. The company is a long established and successfully run business. MWY's competitive advantage is its end-to-end business model and ownership of strategic assets along the supply chain which creates barriers to entry. Founded in 1980, MWY purchases, processes, markets and exports woodchips. MWY owns or controls the infrastructure in its supply chain and has strategic processing, storage and export facilities located at three facilities in Geelong, Portland and Brisbane.

Murray River Organics (MRG) is the world's largest vertically integrated organic dried vine fruit grower, producing sultanas, currants, raisins, muscats, clusters and fresh table grapes on 4,726 acres of owned or controlled farmland. Following the recent acquisition of two food distribution businesses, MRG has a growing portfolio of products including dried fruit, nuts, seeds, dried berries, chia seeds, prunes, dates, dried ginger, mango, quinoa, a range of coconut products and rice. These products are sold to 26 countries, with the greatest exposure to Australia, Europe, Asia (China sales are <2%) and the US.

Stay in touch with your Morgans adviser for details on corporate opportunities in 2017.

Stock	Price	Price Target	FY17 Dividend Yield	FY17 Gross Dividend Yield	FY17 PE (x)	Upside to Price Target
Apollo Tourism & Leisure (ATL)	$1.39	$1.44	1.8%	1.8%	16	4%
Ingham's (ING)	$3.16	$4.00	3.7%	5.3%	12	27%
Midway (MWY)	$2.60	$3.00	6.9%	9.8%	12	15%
Murray River Organics (MRG)	$1.25	$1.57	–	–	17	26%

Source: Morgans. Data as at 30 January 2017

Healthcare – dissecting the sector

While the Healthcare sector has improved recently against the broader market (up 6.8% over the last month and up 2.2% over the last 3 months), it is still facing headwinds (over the 6 months the sector underperformed the ASX200 by 11.6%, and over 12 months underperformed by 7.7%) with a broader move into more cyclical names and pressure on higher PE names.

To compound the issue President Trump continues to talk (tweet) about the pricing of pharmaceuticals and rolling back the Affordable Care Act which is effecting stocks exposed to the US. This leads us to adopt a more neutral stance on the healthcare sector generally and recommend clients trim any overweight portfolio positions.

We continue to expect increased volatility and variability across sub-sectors, and believe medtech will remain the standout (prefer **Resmed** over Cohlear), while domestic hospital providers appear to be less impacted (prefer **Healthscope** over Ramsay), but for service providers (Sonic) and pharma/specialty companies (CSL), it's a bit of a mixed bag. CSL's recent 9% profit upgrade was a pleasant surprise and while we continue to view the name as a core holding, with weak overall sector sentiment, the 'Trump' wild card effect and shares trading at an elevated multiple, we are happy to trim any overweight positions for more active clients.

Fixed interest – taking profits

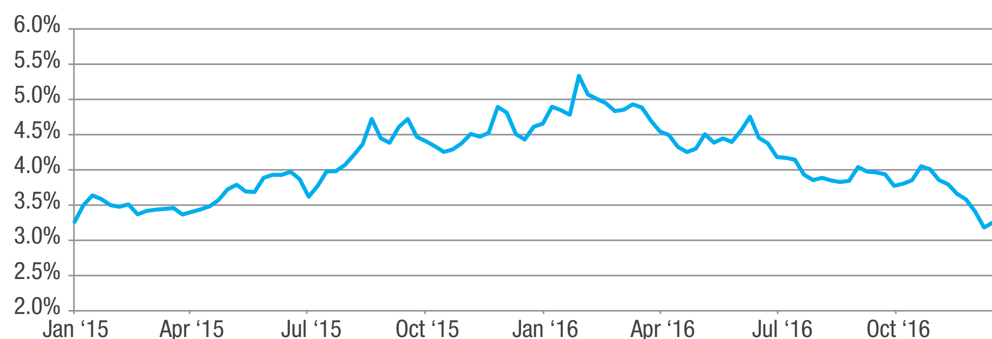
After a very strong December which saw the Tier 1 Hybrid index move 1.53% higher, prices have moved a further 38bp early in CY17. Spreads on 5yr securities have tightened by 40bp on average and interestingly these moves have not been reflected in the wholesale space. ~5yr major bank senior paper continues to trade around 100bp which is the same level seen in early December 2016, while subordinated debt levels continue to sit around ~200bp, again relatively unchanged. We have seen some of this dramatic spread compression in the listed major bank securities unwind which we view as sensible while other financial issues have been supported.

We attribute the strength in the ASX listed space to the redemptions of ANZPA, ORGHA and WOWHC which occurred during December and resulted in ~A$2.7bn of funds hitting investors accounts. Furthermore we saw dividends from ANZ, NAB and WBC also paid during December. With no new supply during the month (with the exception of IAGPD listing on 23 December), investors wanting to increase exposure to the asset class needed to purchase securities on market. This has resulted in sharp price increases and margin compression, particularly for securities with higher issue margins as investors continue to chase income in the current low interest rate environment.

We caution investors about focusing solely on running yield and not considering the total return (yield to call) offered by the security. Yield to call takes into account the amortisation of the security's price back to its face value over time as well as the income paid.

We recommend clients trim positions in AMPPA, ANZPD, BENPE and WBCPE and remain cautious about adding to portfolios at current levels.

5yr major bank tier 1 average trading margin



Source: Bloomberg

Insurance and diversified financials – reporting season preview

We expect few surprises for the Insurance/Diversified Financials stocks this reporting season. AMP, IAG, Suncorp, and Kina have largely provided recent updates to the market.

We see upside risks for **Challenger** on strong recent annuity sales growth and for the health insurers on hospital claims utilisation still being below historical averages. Overall we see AMP as inexpensive on ~15x FY17 PE, with its life business now only ~7% of earnings and future capital return potential existing.

For Computershare, there are some risks to FY17 reported results on a strengthening USD and a soft corporate actions environment, but we still like its attractive double digit earnings growth profile into FY18 and FY19 on cost out and recent acquisitions.

QBE and Computershare retain significant leverage to rising US bond yields and we think this thematic has seen both stocks re-rate in recent times, however, we retain some caution on the speed of US rate increases from here.

We would take some profits in Macquarie at current levels. We see its valuation as full given a still patchy operating environment and the need to prove up growth.

The UK Green investment bank acquisition still needs to get over the line given significant negative public sentiment in the UK.

For more refer to our recent note Reporting Season – not expecting too many surprises published 30 Jan 2017.

High Conviction Stocks

Watch our analysts outline key reasons to buy our recently added stocks in short videos available here
www.youtube.com/MorgansVideo

We make no changes to our High Conviction list this month. However, we see a number of positive catalysts for our High Conviction stocks in the upcoming reporting season.

The key investment themes that defined the last three years are unlikely to define 2017. For a considerable period investors bought equities for yield and bonds for capital gains. We shift away from 'lower-for-longer' trades and enter 2017 with the view that we are entering a new phase in markets, which is less to do with central bank (in)action and more to do with fiscal stimulus and reflating global growth.

We see 2017 as a transitional year, the anticipated US policies to reflate the economy will likely flow on to global growth and commodity prices which bodes well for most sectors of the Australian economy.

Refer to our Reporting season preview published 30 January 2017 for more information.

Morgans' High Conviction Stocks

ASX 100

	Ticker	Price	Price Target	FY17 Dividend Yield	FY17 Gross Dividend Yield	PE 12mf (x)	Upside
► Westpac Banking Corp	WBC	$ 32.35	$31.50	5.7%	8.2%	13.3	5.5%
► Orora	ORA	$2.93	$3.08	3.5%	3.9%	18.6	9.1%
► ResMed Inc	RMD	$9.12	$10.01	2.0%	2.9%	23.1	12.7%
► South32	S32	$2.85	$3.11	4.5%	4.5%	11.4	13.5%
► ALS Limited	ALQ	$6.23	$7.08	1.9%	1.1%	23.1	14.7%

Ex-100

	Ticker	Price	Price Target	Dividend Yield	Gross Yield	PE 12mf (x)	Upside
► Evolution Mining	EVN	$2.12	$2.37	1.7%	1.7%	10.1	13.7%
► GBST Holdings	GBT	$3.89	$4.72	2.7%	3.8%	16.4	25.1%
► SpeedCast International	SDA	$3.71	$4.58	2.2%	3.1%	13.0	26.6%
► Corporate Travel Management	CTD	$17.38	$22.00	1.8%	2.6%	25.5	29.2%
► Kina Securities	KSL	$1.04	$1.49	7.4%	7.4%	8.5	50.2%
► Catapult Group International	CAT	$2.46	$4.32	–	–	–	75.8%
► ImpediMed	IPD	$0.80	$2.08	–	–	nm	160.5%

Source: FactSet Data as at 30 January 2017.

Congratulations – to our award-winning Analysts

Top earnings estimators

Category	Rank	Industry	Analyst
Industry	1	Retailing & Consumer Goods	Josephine Little
Industry	2	Transportation Infrastructure	Nathan Lead
Industry	3	Food, Beverage & Tobacco	Belinda Moore

Top stock pickers

Category	Rank	Industry	Analyst
Industry	3	Health Care	Derek Jellinek

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