April 2017

Investment Watch

The growth conundrum

Global economic growth and inflation indicators are showing signs of improvement. Stronger economic growth has always been a positive driver for equity markets, but rising inflation will also be challenging for income-oriented asset classes. Valuations across most asset classes remain expensive and are vulnerable to any unexpected adverse shocks, especially as investors appear to be factoring in low levels of concern about political instability or President Trump's ability to pass his well publicised campaign promises. Domestically, there is still no clear evidence of a pick-up in economic growth. If anything, recent data has been on the weaker side of expectations, and growth assets (outside of resources) will need stronger cyclical conditions to make meaningful gains.

Equity markets remain at the mercy of abnormal macro-economic conditions such as unconventional central bank interest rate settings and heightened political uncertainty. Making bold portfolio decisions amid such uncertain conditions is a difficult and potentially hazardous exercise; hence our cautious Asset Allocation settings. Despite the challenges facing equity markets, we still think some enduring investment themes will emerge over the course of the year.

On the macro front, the Open Market Committee of the US Federal Reserve met on 15 March and as expected, lifted interest rates. Given this was well flagged, it was delivered with little fuss. Market expectations for an acceleration of the future path of interest rate rises were subsequently watered down post the meeting. We think this view is misguided and the pace of increase may catch the market off-guard in the coming months as US economic data continues to improve. In this scenario, the market-friendly low-volatility environment might just end. We explore the implications of better US economic data in more detail on Page 2.

This month, we explore three investment themes:

1. **Higher global interest rates**
2. **A resurgent resources cashflow recovery**
3. **Rising domestic energy prices**

Key investing themes for 2017 and how to play them

Theme	Best exposures
A US cyclical recovery drives interest rates upwards	QBE and Computershare
Rising domestic energy prices	AGL Energy, Infigen Energy, Genex Power, Senex Energy, Spark Infrastructure and AusNet Services
Resources cashflow resurgence	BHP, RIO, South32 and Oilsearch

Source: Morgans

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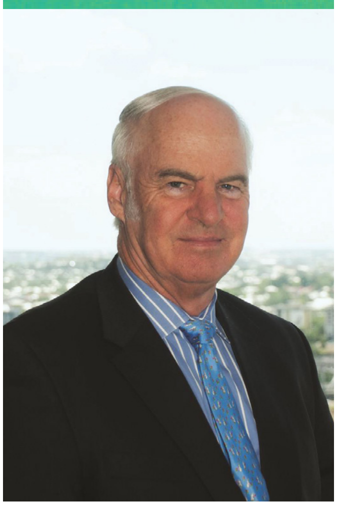

Economics – the Fed and interest rates

After the meeting of the Open Market Committee of the Federal Reserve on 15 March, the Fed released its Summary of Economic Projections. These are the economic estimates provided by the members of the Open Market Committee, plus all the Fed presidents, including those who are not voting at this meeting.

The median level of these estimates is shown in the table below.

The Fed thinks that GDP will grow at 2.1% in 2017. Last December, they thought the growth rate would be only 2%. The Fed also thinks the growth rate will be 2.1% in 2018. This is also up from 2% in December. They think that growth will slow in 2019 to 1.9% and in the longer term real GDP growth will fall to 1.8% p.a.

Higher growth means lower unemployment. The Fed thinks that unemployment will drift down from 4.7% now to 4.5% at the end of 2017 then stabilise at 4.5% in 2018 and 2019. In the longer run, they think it will drift up to 4.7%.

As growth improves, so does inflation. The Fed thinks that headline inflation will rise from 1.9% in 2017 to 2.0% in 2018 and stabilise at 2.0% in 2019 and over the longer term. The outlook for core inflation, which excludes more volatile items, remains close to the level of headline inflation. They think that core inflation will also be 1.9% in 2017. They believe that core inflation will accelerate to 2.0% in 2018. They believe that core inflation will stabilise at 2.0% in 2019. Interestingly, they provide no estimate for the longer run.

The reason that growth accelerates and then slows is because the Fed is continuing to increase the Fed funds rate as time goes by. The Fed thinks there will be three Fed rate hikes in 2017. They think there will be a further three Fed rate hikes in 2018. In 2019 the Fed sees the Fed funds rate going up by 90 basis points. This is more than three rate hikes but not quite four. By the time this process is over at the end of 2019, the Fed funds rate will have achieved the Fed's long-term target of 3.0%.

A bridge too near

We think the Fed's pace of interest rate tightening is too slow. Its pace is not a bridge too far, it is a bridge too near. We think the US economy will grow faster than the Fed thinks. We think that investment in the US economy is recovering faster than the Fed thinks.

This is at least in part because of the greater level of business confidence generated by the Trump administration. We think that US GDP will grow by 2.3% in calendar 2017. We think that US GDP will grow by 2.6% in 2018. This means that the actual growth rate by the end of 2018 will be 0.7% of GDP greater than the Fed believes. Instead of unemployment at 4.5%, the Fed could be looking at unemployment between 4.0% and 3.8%.

This very low level of unemployment has previously set the limit of growth in the US economy. At this low level of unemployment there are no longer enough qualified people in the US labour market to support further growth. The result

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of this has previously been a rapid acceleration of wages growth and a rapid acceleration of core inflation.

The result of this faster growth and lower unemployment (than the Fed expects), will be that the Fed will move faster to increase interest rates. We expect that the Fed will increase the Fed funds rate every quarter for the next two and a half years. We agree that the Fed funds rate will eventually hit a target of 3.0% but we think this target will be reached in mid-2019, not late-2019.

Conclusion

In its summary of economic projections released following the meeting of 15 March, the Fed set a program for gradual increases in the Fed funds rate to 3.0% by the end of 2019. We agree that the Fed funds rate will get to 3.0%. We think these moves in the Fed funds rate will be more rapid than the Fed currently expects.

Federal Reserve Economic Projections – March 2017

Year	2017	2018	2019	Longer Run
GDP	2.1%	2.1%	1.9%	1.8%
Unemployment	4.5%	4.5%	4.5%	4.7%
PCE inflation	1.9%	2.0%	2.0%	2.0%
Core PCE Inflation	1.9%	2.0%	2.0%	–
Fed Funds Rate	1.4%	2.1%	3.0%	3.0%

Sources: Federal Reserve

Equity strategy – a cautious approach to asset allocation

Economic backdrop

We highlighted after the February reporting season that the key issue for local equities remains whether the current period of slower-than-usual growth (outside of resources) is going to turn the corner and firm into a more broader recovery.

The latest official data has not settled the issue. December quarter GDP growth was a strong 1.1%, but the annual rate of growth was only 2.4%, which means the economy is still growing below its potential growth rate of between 3-3.5%, making little real positive impact on unemployment and consumer confidence. The latest official data also showed a strong rise in corporate profits in the December quarter, but it was a rather lopsided outcome, with mining sector profits, boosted by the recent run-up in commodity prices, accounting for the lion's share. Also, there was one outright piece of negative news, with a small fall in employment in February, and an unexpected rise in the unemployment rate, to 5.9%, although not too much should be made of what has recently been quite a volatile indicator.

While we remain confident of an eventual turnaround in the cyclical rebound driven by the mining economy, without any clear catalysts we see some short-term risks particularly with corporate profits not yet signalling a durable recovery. If anything post-reporting season, the most recent analysis on the economic front is a bit less encouraging for markets than before.

Pricing the market

Equity valuations are not as demanding as they were earlier in the year with the Bloomberg consensus estimate for the forward looking P/E ratio at 15.6x implying slightly better value on offer, which may appeal to tactical investors. The 4.3% dividend yield should also find support in a risk-off environment. Industrials ex Financials, however, remain elevated trading on a forward P/E of 19x, with investors positioned for better growth. Consensus EPS growth forecasts for FY17 continue to trend higher, moving from 12.9% to 13.7%, but Industrials revisions are flat as resources continue to drive market growth. Again highlighting that any broad-based market gains will depend on the economy picking up from its current lacklustre rate of growth.

Themes

Despite the challenges facing the domestic economy, we think some durable investment themes will emerge over the year. We highlight some of these in the below table.

Refer to our recent report on 2017 Market Themes published 29 March 2017 for more information.

Key investing themes for 2017 and how to play them

Theme	Best exposures
A US cyclical recovery drives interest rates	QBE and Computershare
Rising domestic energy prices	AGL Energy, Infigen Energy, Genex Power, Senex Energy, Spark Infrastructure and AusNet Services
Resources cashflow resurgence	BHP, RIO, South32 and Oilsearch
Diversify internationally	Recommended LICs and ETFs
Inbound tourism	Sydney Airport, Mantra, Sealink, Helloworld, Apollo, Ardent Leisure, Star Entertainment
Rise of the Chinese consumer	Treasury Wine Estates, Blackmores, Bellamy's Organic, A2 Milk, Capilano Honey
Smarter Healthcare – the empowered consumer	Resmed and Volpara
Retail disruption and the Amazon threat	Beacon Lighting, Lovisa and Qube Logistics
The push for financial deregulation	Westpac and US Banks (ASX: BNKS)
The digital marketplace	NextDC, Vita Group and Megaport

A US cyclical recovery drives interest rates upwards

The most important event for equity investors in 2016 was the reversal in bond yields (interest rates) off highly abnormal lows in mid-2016, accelerated by Trump's surprise US election victory and promises of improved growth (expected to lift 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 and robust earnings.

Based 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.

On the surface, the transmission mechanism for higher global interest rates will result in an increase in the cost of capital and therefore lower asset valuations. However, the prospects for improving growth and inflation should flow through to better earnings, with cyclically sensitive stocks the key beneficiaries.

Positioning for a cyclical recovery

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 over the short term providing investors opportunities to accumulate high yielders that are oversold in market over-reactions.

We have consistently flagged that path to the normalisation of global monetary policy is going to be slow and bumpy. It is paramount that investors appreciate the economic and interest rate environment has now begun its shift. Therefore, equity strategies that performed best in the last five years are unlikely to be those that deliver outperformance in the years ahead.

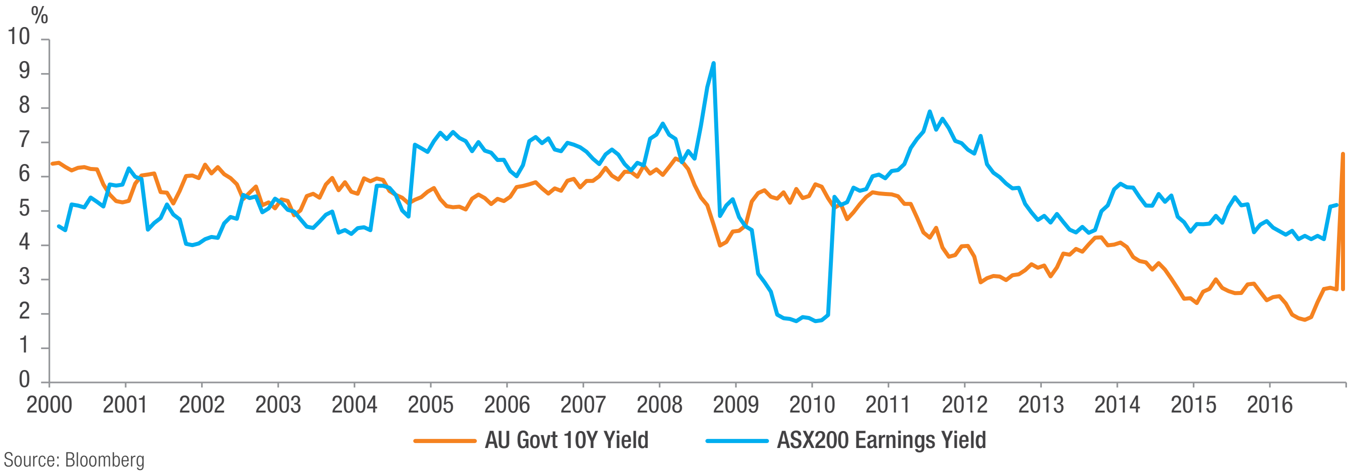
That said, we are not overhauling our current investment strategy but simply advocating a gradual shift in exposure, allocating slightly less capital to defensive equities and slightly more to the cyclicals, in line with recent moves in the Equity Model Portfolios over the last few months. Our focus on quality and conviction also aims to recommend stocks that can thrive independently of the interest rate environment (ideally) and/or regardless of political machinations elsewhere. Investors must continually adapt to new realities.

Financials – the key beneficiary

The financials sector is arguably the space most likely to benefit from rising interest rates across the equity market. Most financials stocks (banks, insurers, registry maintenance companies) benefit in some way from rising interest rates:

- Banks benefit as a lift in the yield curve allows them to charge higher interest rates on customer loans; meanwhile, the cost of some bank deposit funding does not really alter with an upward move in the yield curve, e.g. transaction deposits which offer little to no interest. Banks also hold excess shareholder capital, as required by the regulator, which they invest in fixed interest/liquid securities providing additional leverage to rising yields.
- Insurance companies take upfront premium payments (known as a 'free float') and invest them in bonds while waiting to see what payments they must make for insured claims over the year. Similar to banks, insurers also invest excess regulatory capital in bonds. Higher interest rates thus benefit their earnings.
- Registry maintenance companies (e.g.. Computershare) accumulate float balances through a variety of activities like processing and payment of dividends, trust activity, which sees them hold a portfolio of short-dated fixed interest securities as part of their regular operations.

Equity market remains attractive against current interest rate settings



Source: Bloomberg

Energy and utilities – rising domestic energy prices

In eastern Australia, the bulk of physical electricity is sold through the National Electricity Market (NEM). Each region (Queensland, New South Wales, Victoria, South Australia and Tasmania) of the NEM has its own reference price, but interconnection between the regions means supply/demand in one region can influence the pricing of another. Generators compete with each other for dispatch of their generation to meet market demand.

Wholesale electricity prices have risen considerably over the last year and forward contract prices indicate the market expects this to continue. The price rise has been driven by numerous factors, including closure of thermal plants and penetration of renewable generation in the energy mix, increasing costs for gas-fired power generators due to rising domestic gas prices, weather events, transmission constraints, and increased demand in Queensland from LNG production. The stock with probably the best exposure to this rising wholesale price thematic is AGL Energy (**AGL**) due to its 'long' generation position. Origin Energy's (**ORG**) exposure is somewhat diluted by its upstream gas activities and its LNG export interests.

The market price of renewable certificates has also been rising, as the market expects a shortfall in LGC supply by 2018 to achieve the Renewable Energy Target (RET). We expect the RET will incentivise the construction of a significant amount of renewable capacity over coming years. The stock with probably the best direct exposure to higher LGC prices is Infigen Energy (**IFN**), which has a portfolio of operating wind farms and a pipeline of development opportunities. Genex Power (**GNX**) is building a solar plant in far north Queensland and is developing a pumped storage hydro project to take advantage of wholesale market volatility.

The remaining cost element of the retail price are network costs (the 'poles and wires'). These costs are regulated by the Australian Energy Regulator (AER), and are reset every five years (different timing for different assets). We think the recent decline in network costs is likely to have bottomed as Government bond rates lift off all-time lows. Successful legal challenges to regulatory decisions may also see higher costs. ASX-listed companies within this segment of the electricity value chain include AusNet Services (**AST**), Spark Infrastructure (**SKI**), and DUET Group (**DUE**) (under a takeover bid from Cheung Kong Infrastructure – CKI).

A report by the Australian Energy Market Commission on retail price trends estimated that the sum of generation and retailing costs accounted for about 40-50% of the residential price. Green costs related to environmental policies add 5-10%, while network costs contribute 40-50%. Given the above, we expect retail electricity prices may rise materially over time.

Who may be negatively impacted?

We expect companies with a high proportion of electricity in their cost base will be negatively affected. Brickworks (**BKW**) has noted a higher forward electricity cost already. Higher prices are likely to negatively affect companies operating on skinny margins which may not be able to pass costs onto customers. Mums and dads are also likely to feel the impact through higher electricity bills.

Gas is a key input in both fertiliser (agriculture) and ammonium nitrate (explosives) production. Both Incitec Pivot (**IPL**) and Orica (**ORI**) face headwinds from a rising gas price. In FY17, ORI's Kooragang Island plant in Newcastle will incur a much higher new gas contract. Unless gas prices fall, IPL has said that its Gibson Island facility in Brisbane will be shut down as it won't be economic to run when a new gas contract is in place in FY19.

For more coverage refer to our Utilities analyst Nathan Lead's comprehensive sector video update on Energy Security and Power Prices.

Resources cashflow resurgence

Until early 2016, mining companies had endured a five-year downturn as the onset of new mining supply drove a correction in commodity prices. The miners adapted, often painfully and largely under new management, by cutting dividends and growth while re-focusing on productivity, cost reduction and cash margins. Stretched balance sheets were repaired in protection against a potential prolonged downturn.

Some key commodities then enjoyed a surprise bounce in 2016 due largely to Chinese policy decisions (iron ore and coal). The major miners enjoyed significant bounces in both earnings and dividends assisted by their reform. With balance sheets largely repaired, the majors' rhetoric on capital allocation very much remains directed at sustaining higher shareholder returns (payout ratios, buybacks). This is pleasing for shareholders, but also infers poor confidence in the trajectory of commodity prices, which should be noted.

We don't blame investors for having similarly mixed confidence in commodities, China and global growth. However several factors support an overweight sector exposure to Resources:

Low China downside

China is in robust shape, cycling GDP growth of 6.5%. With the mid-term leadership transition approaching in November, we think the risk of China's economy being allowed to slip in 2017 is low.

Moderate Global growth upside

Markets have already shown their responsiveness to Donald Trump's proposed US economic agenda. A stronger US economy would support stronger global growth which is in turn positive for commodities.

Moderate sector downside

Balance sheets are in strong shape, operating margins are strong and there is no evidence to suggest that the majors are about to relax their cost focus. Investments in the lowest cost producers offer solid downside protection should commodity prices weaken.

Strong investor upside

Our market feedback suggests that global investors remain under-exposed to commodities in general as the pain of the 'bust' remains fresh for many. We note that generalist investors are often late to any given commodity cycle.

Overall, we think that investors can safely position in our sector favourites to gain exposure to a solid upside scenario re global growth, without assuming excessive risk.

High Conviction Stocks

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

Maintaining our conviction

We remove **South32**. It's been a rocky month for resources, with the USD fluctuations and metal price jitters weighing on our miners. Part of the rationale behind our High Conviction Add call on S32 was the probability we saw for additional shareholder returns. This was confirmed recently, with S32 announcing plans to return an extra US$500m to shareholders. We still see good value on offer in S32 at these levels and still maintain our Add recommendation. And we also maintain a high degree of confidence in the company's outlook and market position. However, we are pulling the stock off our High Conviction list this week given some short-term potential negative catalysts we see on the radar over the next month. Following >100% return since inclusion in the ex-100 list two years ago, we also remove **Corporate Travel Management** this month, we still rate CTD highly however after strong recent share price appreciation, the stock is now trading within 10% of our A$22.00 price target and consequently we remove it from our High Conviction list.

Refer to our latest High Conviction Stock list published 3 April 2017.

Morgans' High Conviction Stocks

ASX 100

	Ticker	Price	Price Target	FY17 Dividend Yield	FY17 Gross Yield	PE 12mf (x)	Upside
▶ ResMed	RMD	9.41	10.01	1.9%	1.9%	24.4	8%
▶ Orora	ORA	2.92	3.22	3.6%	4.0%	19.0	14%
▶ Macquarie Atlas Road	MQA	5.05	5.84	4.0%	4.0%	20.9	20%
▶ Oil Search	OSH	7.29	9.70	1.6%	1.6%	27.2	35%

Ex-100

	Ticker	Price	Price Target	FY17 Dividend Yield	FY17 Gross Yield	PE 12mf (x)	Upside
▶ Beacon Lighting	BLX	1.79	1.92	2.7%	3.8%	20.9	11%
▶ Bapcor	BAP	5.74	6.38	2.2%	3.1%	21.7	14%
▶ SpeedCast	SDA	3.45	4.72	2.1%	3.0%	12.8	40%

Source: FactSet Data as at 3 April 2017.

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