May 2017

Investment Watch

Reflation trade going on a hiatus

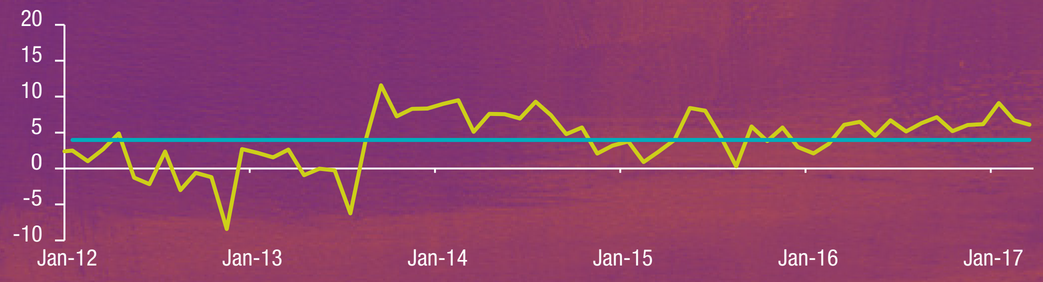
The ‘Trump rally’, which saw cyclical stocks rise strongly, bonds sell off and the U.S. dollar strengthen, has weakened as investors have reassessed the Trump administration’s ability to implement its economic agenda. Bond yields have retreated as investors seek a safe haven in the face of geopolitical rumblings and both bonds and bond proxies such as property and infrastructure have benefited, while cyclically leveraged equities have temporarily stalled. More positively, recent data suggest that the world economy is strengthening, which is supportive of growth assets, although on current expensive valuations there is little room for corporate performance to fail to deliver. Domestically, the latest data suggest, tentatively, that the economy may be picking up out of its post-mining-boom slowdown, which would be helpful for growth asset performance, although the common global headwind of elevated asset valuations is also present here.

The Federal Budget comes squarely into focus this month, putting the Government’s fiscal management in the spotlight. The IMF recently forecast a $27 billion improvement in federal and state tax revenue over the next four years to bring the combined budget position back to surplus by 2020, two years earlier than it predicted six months ago.

The improvement in the budget outlook reflects the IMF’s belief that stronger commodity prices and lower interest rates will support growth. If borne out, it could cement Australia’s AAA rating and reduce the burden on the Government to find further savings. We explore the economic backdrop in more detail on page 2.

As we have come to expect Health and Aged Care are likely to be the most affected by potential changes announced in the budget. We look at the implications of the proposals that have been tabled by the Government in the lead up to the Federal 2017-18 Budget on page 4. We look at the health of the consumer. While tax breaks are likely to provide some relief for middle-income earners, higher out-of-cycle interest rate rises and higher energy prices are weighing on spending. We update our view on the retail sector on page 4.

Australian business confidence showing resilience



Source: IMF

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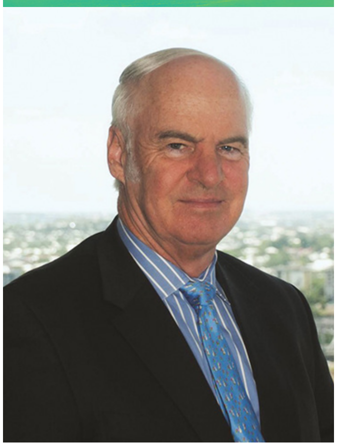
Michael Knox, our Chief Economist, discusses the outlook for employment. Visit our website for our note **Where jobs come from in the Australian economy** published 18 April 2017.



Economics – the IMF and the Australian budget deficit

In this issue, we look at the outlook for the Australian economy and the Australian budget deficit based on the April update of the International Monetary Fund Economic Outlook. The International Monetary Fund (IMF) has built a reputation as an unbiased forecaster. For this reason, its estimates are widely used by rating agencies.

The Australian Government has a spending problem. Back in 2007, immediately before the Great Financial Crisis, the Australian Government was spending a total of 34.3% of GDP. The Government of the day, led by Kevin Rudd, decided to expand spending to provide short-term emergency stimulus to the Australian economy. Spending then rose by 3.6% of GDP to a total of 37.9% of GDP. When the crisis was over, spending then began to fall. By 2012, it had declined to 36.7% of GDP. This was still 2.4% higher than the level in 2007.

The problem was spending got stuck at that level and didn't fall any further. The levels of expenditure for 2016 and the estimates for 2017 and 2018 are shown in the figure below. We can see that in 2016, the Australian Government spending was 37.3% of GDP. This is actually 0.5% higher than in 2012. It is also 2.9% higher than the level in 2007. This increase in spending explains all of the budget deficit in 2016 of 2.7% of GDP.

The IMF has a pretty optimistic outlook for the Australian budget over the next couple of years. It thinks that in 2017, Government spending will fall to 36.8% of GDP. This will still be 0.1% of GDP higher than in 2012 and 2.5% higher than in 2007. The result of this restraint on spending reduces the budget deficit to 2.2% of GDP.

In 2018, the total of Government spending declines to 36.2%. This is finally 0.5% lower than in 2012. It is still 1.9% higher than in 2007. Still, the budget deficit should decline to 1.3% of GDP.

Eventually, the IMF sees spending stabilising at around 35.4% of GDP. This finally happens in 2020. This level of Government spending will still be 1.1% of GDP higher than in 2007. Still, with estimated revenue in 2020 at 35.6% of GDP, this level of spending is enough to generate a wafer-thin surplus of 0.12% of GDP.

The difficulty Australia has getting back to balancing its budget really demonstrates that when Governments make a temporary increase in spending, the word 'temporary' means that spending can last almost forever.

Economic Outlook

The IMF does not just have a reasonably optimistic outlook for the Australian budget deficit. It also has an optimistic outlook for the Australian economy. After growth of just under 2.5% in GDP in 2016, the IMF has GDP accelerating to 3.1% in 2017. This improvement results from an increase in exports. Australia is rapidly becoming one of the world's largest exporters of liquified natural gas. This is leading us to an improved trade balance which has recently moved into a small surplus. It is also resulting in a reduced current account deficit which has been recently moving into a smaller deficit.

The Australian Government has a spending problem.

This improvement in exports is the reason for the improvement in growth in 2017. The IMF believes that Australian growth will then stabilise at 3% of GDP in 2018 and 2.9% of GDP in 2019. Growth then declines slightly to 2.8% of GDP in 2020 and 2.8% of GDP again in 2021. The IMF suggests that this healthy growth of GDP eventually leads the Australian unemployment level to decline to 4.9% in 2020. This is generally around the level regarded as full employment.

Conclusion

The IMF has built a reputation as an unbiased forecaster. The IMF has a pretty optimistic outlook for the Australian budget for the next couple of years. It believes the Australian budget deficit will decline from 2.7% of GDP in calendar 2016 to 2.2% of GDP in calendar 2017. In calendar 2018, the budget deficit should fall further to 1.3% of GDP.

This improvement in the budget deficit is primarily because of the introduction of some modest discipline in Australian government spending. Those who have looked at the record since 2007 know that this modest level of discipline has been a long time coming.

Levels of expenditure for 2016 and the estimates for 2017 and 2018

Year	2016	2017	2018
General Government Expenditure % GDP	37.3%	36.8%	36.2%
General Government Revenue % GDP	34.6%	34.6%	34.9%
General Government Net Borrowing	-2.7%	-2.2%	-1.3%

Sources: Federal Reserve

Equity strategy – shifting sands

Outlook for Investment Markets

Recent data suggest that the global economy is strengthening, which is supportive of growth assets, although on current elevated asset valuations there is little room for earnings disappointment. Ahead of what is a traditionally weaker period (May-June) for markets we prefer to err on the side of caution. While we are confident in a cyclical turnaround over the medium term, we need to see signs of better earnings momentum before getting more comfortable with a much broader based rally. In this environment investors should concentrate on stock over sector exposure for alpha. We feel that holding higher levels of cash is prudent at this time, and will look to deploy on any pullback of our most preferred exposures.

The domestic business cycle has proved hard to read. For some considerable time, the economy has continued to bumble along at a slower-than-usual rate of growth, with no knockout evidence that it risked slowing to unacceptably slow growth or that it was accelerating back to the pace it enjoyed before the mining projects boom came to an end.

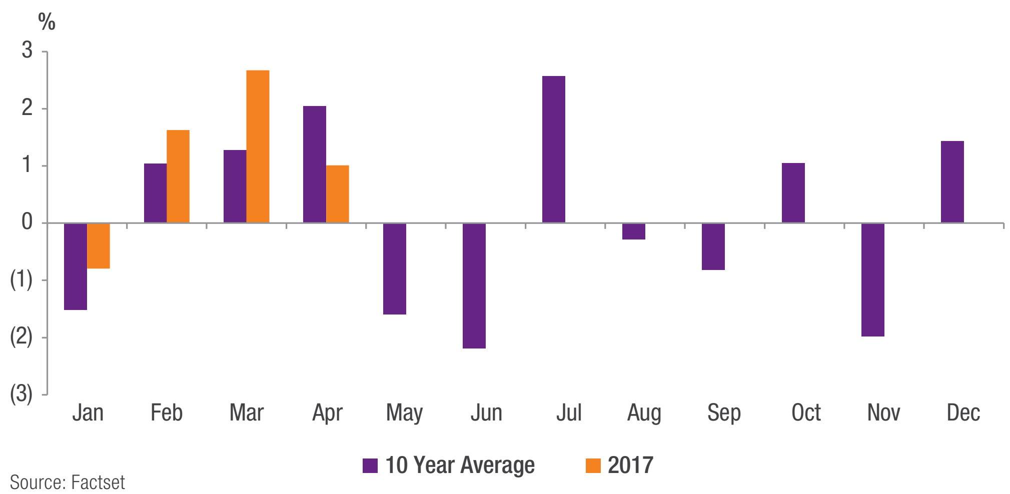
The latest data do not settle the matter, either, though this time round they generally lean more towards the acceleration view. The March employment report was, at face value, a great result. Seasonally adjusted, there was a 60,900 increase in employment, more than all of which (74,500) were full-time, with a corresponding 13,600 decrease in part-time unemployment. Although there was a big reported rise in jobs, the unemployment rate was unchanged at 5.9%, because at the same time more people entered the labour force to look for jobs (there was a rise in the participation rate), which is also a good sign of labour market strength. But 'at face value' and 'reported rise' are important qualifications. The data from the statisticians have been unusually volatile and some commentators feel the series is not as reliable as it might be. Other evidence, however, has also been on the bright side.

The latest (March) quarterly business opinion survey from National Australia Bank (NAB) found 'an encouraging picture of both current business activity and the outlook. Leading indicators mostly improved in Q1 2017, which has been reflected in better outcomes in terms of investment and hiring intentions going forward. Both near and longer-term employment expectations recorded solid improvements.' The three sectoral indexes compiled by Australia Industry Group all moved into expansion territory in March. The services index, which had previously been signalling that the sector had been going backwards, joined the manufacturing and construction indexes in showing positive growth.

At the same time, there are still soggier readings from other indicators. The ANZ–Roy Morgan survey of consumer confidence, for example, has been falling since the middle of last year; in particular, households' views of the economic outlook during the next five years have been falling since the start of this year and are now well below long-run levels. There are also well-known risks in the housing market – not just the risk of excessive prices unwinding, but also the prospect of house construction turning from supporting GDP growth. On both the Commonwealth Bank and NAB calculations in their latest forecasts, the volume of housebuilding will grow modestly this year but contract a bit next year.

If the latest upbeat indicators are the better signal, however, and the economy is indeed looking a bit perkier, Australian shares could make further progress. But as in many other markets, corporate profits will need to live up to investors' high expectations. With the market trading on a forward-looking P/E ratio of 16x earnings, there is not much room for macroeconomic or corporate underperformance.

ASX 200 seasonality – average returns by month (2006-2016)



Source: Factset

Healthcare – no major reforms expected

While a recent JWS Research poll has shown that healthcare, Medicare and hospital funding are top concerns for most Australians, we believe the Coalition Government has much less of an appetite for broad sweeping healthcare reform in the upcoming budget, especially on the heels of a highly contested 2016 Federal Election that drew battle lines around numerous healthcare issues (ie from protests to lift the Medicare Benefits Schedule (MBS) rebate freeze, to the Liberal Party stalling pathology bulk-billing cuts to appease angry voters, to the Labor Party's claims the Coalition would privatise Medicare). So we aren't expecting major shifts in our investment case across the healthcare space. That said, we outline below what we do expect to come out of the Federal budget.

Medical Centres/Pathology/ Diagnostic Imaging (Sonic Healthcare, Primary Health Care, Healthscope) – a net positive. We expect the reintroduction of MBS indexation for GPs and diagnostic imaging (as has been well-flagged), with possible changes to proposed bulk-billing cuts, but we don't expect to see any improvements to rental arrangements for pathology collection centres.

Aged Care (Japara, Regis Healthcare) – no impact. A sector already battered and bruised following changes to ACFI with the MYEFO and requiring reform consultation throughout 2017 on the heels of the recent legislated review that recommended numerous options for a sustainable funding strategy.

Hospitals/Insurers (Ramsay Healthcare, Healthscope, Medibank) – no impact. Government reviews are ongoing, including a report from the Independent Hospital Pricing Authority which should help to highlight differences paid for devices in the private and public health systems.

Healthcare – most preferred exposures

	Price (A$)	Target Price (A$)	EPSg FY18 (%)	Gross Yield (%)	12m Capital Upside (%)	PE NTM (x)
Ramsay Healthcare (RHC)	70.57	88.40	11.4	2.7	27.2	24.7
ResMed (RMD)	9.19	10.01	7.3	2.8	7.7	23.7

Prices as at 1 May 2017

Retail – tough but perhaps some budget relief

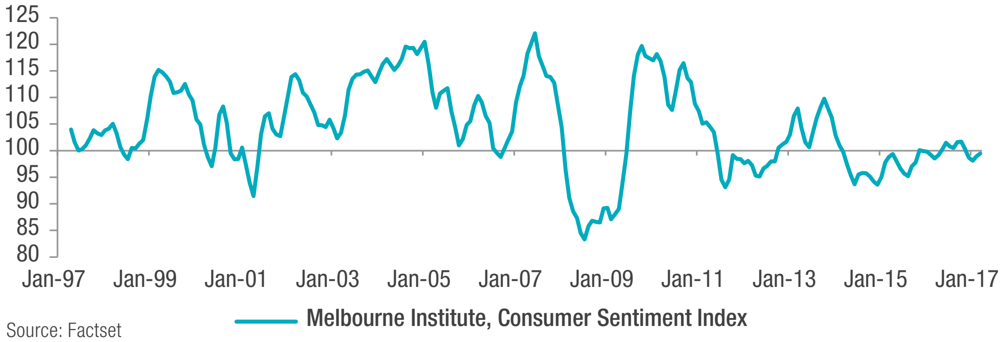
Retailers are faced with more difficult trading conditions than they did in 2016, although pockets of strength are evident. Unseasonable weather has elevated inventory positions, particularly in the apparel and department stores. This has increased clearance activity and dented gross profit margins in general. The February reporting season revealed a real divergence between retail categories with traditional shopping centre retailers underperforming, while niche retailers showed more resilience in both revenues and margins. We continue to watch the housing market for any signs of distress (given its importance as a retail driver) but expect solid conditions to persist, supported by historically low interest rates.

The 2017-18 Federal Budget may provide better news for some retailers. In April the Government's hard-fought change to the corporate tax rate for small businesses also altered the definition of 'small business' to now include companies with up to $10m (previously $2m) in annual turnover, meaning budget pledges to extend a number of tax concessions to more Australian companies will be realised. We believe this will mean companies up to A$10m can access the A$20,000 asset write-off program (unlimited assets up to A$20,000 in value) in addition to a tax rate cut from 28.5% to 27.5%. While the asset write-off program is due to expire 1 July 2017, we think there is a strong chance it will be extended given the support from small business Minister Michael McCormack.

Stock impact

This will be positive for those listed companies leveraged to office equipment (Officeworks), electronics (laptops, smart phones, tablets – JB Hi-Fi/ Harvey Norman) trade equipment (Bunnings) and vehicle sales (A.P. Eagers/ Automotive Holdings). So **Wesfarmers, Harvey Norman** and **JB Hi-Fi** should ultimately be the winners here. We know from last year that JB Hi-Fi and Harvey Norman experienced particularly strong trading as a result of the tax incentives.

Consumer sentiment remains subdued



Source: Factset

Small Resources – Noosa Conference

Morgans is pleased to be supporting the seventh instalment of the annual Noosa Mining Conference in July. The Noosa conference is rapidly developing a profile as the Diggers and Dealers of the east coast, profiling a host of emerging mining juniors across a range of commodities. The conference is about companies transforming through exploration, discovery and/or the development of a resource. It's not about the major diversified resource companies, BHP, Rio Tinto and their ilk, which provide portfolio exposure to the sector. We recommend the conference to risk tolerant investors in the resources sector. Morgans clients can register their attendance at no charge.

ASX Small Resources Index vs Base metals: Junior Resource companies are trading at a fraction of their boom time highs, despite commodity prices holding strong levels

Source: Factset

Throughout 2016, ASX-listed junior miners enjoyed a strong rebound from their 13 year lows set in mid-2015, led by strong gains in gold stocks. The S&P/ASX Small Resources Index bounced 75% off its lows but there is still opportunity here, in our view. This collective of stocks is still only capitalised at about one-quarter of its boom-time highs achieved in 2008 and 2011. We're not saying that the next mining boom is imminent, but simply that positive fundamental signals continue to accumulate and that risk tolerant investors should be positioning for that inevitability. After all, junior miners always have and always will be cyclical.

For our latest investment views refer to our note Resources Sector – Commodity Forecasts Update published 11 April 2017 on my.morgans.com.au

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Property – running through an appraisal

With bond yields back to around 2.60% at the time of writing (from a high of 2.97% in March), the REITs have performed strongly over the past month versus the broader market. Some groups including Goodman Group, Dexus Property Group (exposure to Sydney prime CBD office) and Investa Office Fund (M&A activity) have hit 12 month highs.

While we expect property cap rates will likely moderate during 2017, there is still strong international demand for Australian real estate assets given the relative yield on offer. As a result, direct property acquisitions for listed REITs remain challenging given current pricing which may lead to an increase in M&A activity (currently Generation Healthcare REIT, Investa Office Fund and Centuria Urban REIT are in play) as well as further share buy-backs. We also expect some REITs will continue to sell non core assets into this strength and recycle capital for development pipelines/debt reduction. In general, balance sheets remain solid with gearing levels averaging around 30% for most groups.

We continue to prefer **Aventus Retail Property Fund** (AVN) which offers a FY18 distribution yield of around 6.8%, with good organic growth available within the existing portfolio, as well as acquisition opportunities in a highly fragmented market. While retail sales have been slower across the traditional retail REITs, we think AVN's exposure to large format retail is a differentiator.

While not a REIT, but leveraged to the property sector, **Aveo Group** (AOG) has an investor day on 10 May. AOG is our preference in the aged care/retirement sector. The stock is currently trading at NTA, 16/17x PE (vs NZ peers on c20x) and is one of the very few companies in the market to provide two years of forward guidance.

We note that other preferred yield plays include the following:

1. **Viva Energy REIT** with distributions underpinned by fixed 3% rental increases until 2025. Viva Energy REIT owns a portfolio of 425 service stations valued at $2.1bn.
2. **Cromwell Property Group** has an attractive 8.6% 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 in the near term as this would reduce gearing levels.

High Conviction Stocks

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

Maintaining our conviction

We make just the one change this month (adding Westpac) and will look for an opportunity to add to the list on any weakness.

We believe renewed focus on the part of the Government and regulators to reduce heat in the housing market will prove positive for the banking sector. **Westpac** offers a relatively low risk profile in terms of loan booking position due to skew to Australian residential mortgages and stands to benefit most from repricing of investor home loans. It has relatively low reliance on treasury and markets income, which is a volatile income stream. And despite the low revenue growth environment, Westpac has not been compromising on investment spend particularly on technology infrastructure. We expect Westpac to outperform its major bank peers over the next 12 months.

For more detail refer to our latest High Conviction Stock list published 2 May 2017.

Morgans' High Conviction Stocks

ASX 100

	Ticker	Price	Price Target	FY18 Dividend Yield	FY18 Gross Yield	PE 12mf (x)	12m TSR
Macquarie Atlas Road	MQA	$5.51	$5.74	3.8%	3.8%	19.8	8%
Orora	ORA	$3.07	$3.22	3.9%	4.4%	17.7	9%
ResMed	RMD	$9.19	$10.23	2.1%	2.1%	24.0	13%
Westpac (*)	WBC	$34.83	$39.00	5.4%	7.7%	13.2	20%
Oil Search	OSH	$7.16	$10.22	2.2%	2.2%	19.7	45%

Ex-100

	Ticker	Price	Price Target	FY18 Dividend Yield	FY18 Gross Yield	PE 12mf (x)	12m TSR
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 2 May 2017 (*) New addition

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