June 2017

Investment Watch

Set for a better second half

Growth oriented assets have performed well year to date, initially on the 'Trump trade' theme of a revived U.S. economy, but more recently on evidence of faster global economic growth and a favourable outcome from the French presidential election.

The stronger state of world business activity will provide further support for global growth assets, but there is little room for slippage. If corporate profits deliver to investors' high expectations, then the gradual improvement in asset classes will continue, but the risk is that current expensive valuations (especially in the U.S.) are priced for perfection and could be vulnerable to setbacks.

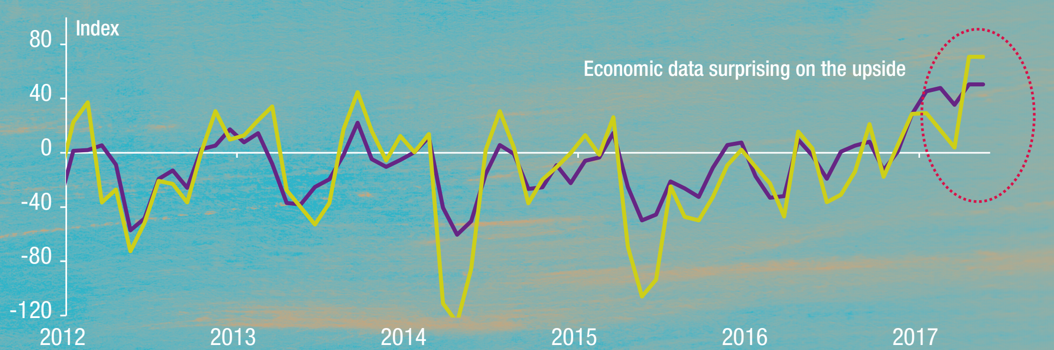
Defensive assets such as bonds have lagged and will be under further pressure if, as seems likely, bond yields rise over the next year – an exception is infrastructure, which remains in high demand.

In Australia, both the RBA and Treasury have recently predicted better times ahead. Though recent data has been patchy, an improvement in local prospects will be needed to help justify somewhat expensive share valuations. It will require confirmation that the more optimistic views on the economy and on growth in corporate profits over the coming year are finally taking shape, to justify current pricing and to see share gains start to match those achieved overseas. We look at the health of the market ahead of the August corporate reporting season on Page 3.

Despite arriving with little fanfare, the Federal Budget provided some genuine surprises and we look at implications on healthcare on page 4 and banks on page 5.

The National Broadband Network (NBN) has changed the competitive landscape dramatically and by June 2017 the NBN will account for 30% of all household fixed line internet connections, which makes the implications hard to ignore going forward. We look at what this means for Telstra and the sector on Page 6.

Citigroup Economic Surprise Index



Source: Bloomberg

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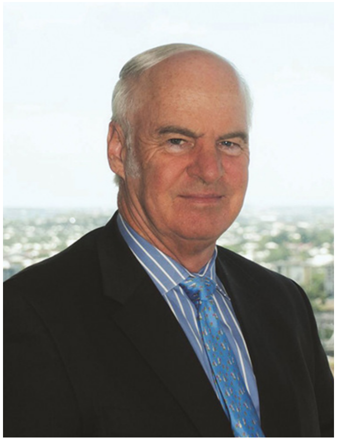
Michael Knox, our Chief Economist, discusses **Why US Corporate Tax Cuts Will Happen.** Listen to the podcast now.



Economics – can Trump get corporate tax cuts?

There are two major sources of non-partisan information on the financial effects of US tax legislation. The Congressional Budget Office only deals with legislation. Proposals and campaign promises are handled by the Committee for a Responsible Federal Budget (CRFB).

In this issue, we look at two recent commentaries by the CRFB. The first is on the revised healthcare bill known as the American Health Care Act (AHCA), which has recently been passed through the US House of Representatives. The second is on the White House release on a framework for tax reform, released on 26 April 2017.

Healthcare Law

Savings necessary to allow corporate tax cuts might be found in two areas. The first is the repeal of Obamacare. The second is the repeal of corporate tax deductions.

The AHCA to repeal and replace the Affordable Care Act (ACA or Obamacare) was passed by the United States House of Representatives on 4 May 2017. In a publication on 3 May the CRFB estimated that the budget savings would only be US$155 billion over a 10 year period. This provides support to the budget of only US$0.15 trillion over 10 years.

This reduction in savings means that almost all of the savings required to support corporate tax cuts must come from the repeal of corporate tax deductions.

Trump's Tax Plan

The tax plan provided by President Trump on 26 April provides a much broader range of tax cuts than were costed in an earlier plan by Speaker of the House Paul Ryan, prior to the November 2016 election. Paul Ryan's program was firstly individual tax cuts. This was brought about by reducing the number of tax brackets that individuals would need to pay from five, to only three. These tax brackets were 10%, 25% and 35%.

Secondly, the corporate tax rate was to be reduced to 20%. These

> Paul Ryan's tax plan might be referred to as the Basic Model tax plan. It is a Ford, not a Lincoln. Donald Trump's plan has all the optional extras. It is a Lincoln, not a Ford.

tax cuts were funded with the repeal of a number of corporate tax deductions (the repeal of the corporate tax deduction on imports is known as the Border Adjustment Tax). Paul Ryan said these tax cuts could be provided in a way that was fully funded by the repeal of corporate tax deductions. This meant there would be no effect on the budget deficit. The result was that such a law could be passed through the US Senate with a simple majority of votes. The Republicans with 52 US Senators would be able to pass this into law.

Paul Ryan's tax plan might be referred to as the Basic Model tax plan. It is a Ford, not a Lincoln. Donald Trump's plan has all the optional extras. It is a Lincoln, not a Ford. President Trump's plan with all the optional extras is much more expensive and hence, much less achievable.

In total, we calculate, based on the work of the CRFB, that the total cost of the optional extras in the Trump tax plan is US$4.3 Trillion over 10 years. We believe these cannot be funded by repeals in corporate tax deductions. This tax plan would appear to have no chance of being passed through the US Senate in its current form.

Conclusion

There are two possibilities. The first is that the Trump tax plan is purely a marketing document. Trump is showing all the optional extras but would be prepared to accept Ryan's basic tax plan. He is showing a Lincoln, but would be prepared to sell a Ford.

The second possibility is that the passage of the basic tax plan would allow the Republican party to gain more than 60 seats in the US senate in the 2018 mid-term elections. This would allow the Republicans to pass some of the extra tax cuts in the Trump tax plan; these would be funded by a budget deficit. Having bought a Ford, the public might come back later for the Lincoln.

US Policy Costings

Policy	2018-2027
Paul Ryan Basic Tax Plan	
Change rate structure to 10%, 25%, 35%	$1.5 trillion
Reduce corporate tax rate to 20%	$1.7 trillion
Total for Paul Ryan basic tax plan	**$3.2 trillion**
Donald Trump Optional Extras	
Reduce corporate tax rate from 20% to 15%	$0.5 trillion
Repeal individual AMT	$0.4 trillion
Double the standard deduction	$1.5 trillion
Repeal estate tax	$0.2 trillion
Reduce pass-through business tax rate to 15%	$1.5 trillion
Repeal the net investment income surtax	$0.2 trillion
Total for Donald Trump optional extras	**$4.3 trillion**

Sources: CRFB

Equity Strategy – a mid-year review of market expectations

With confession season now in full swing, we've taken a look at momentum in consensus EPS forecasts across the ASX300. Generally speaking, large cap profit forecasts have proven much more robust than smalls-to-mids, where weakness has been concentrated in retail and notable problem stocks (Vocus, Vita Group).

Large cap resilience masks small-cap difficulty

The large cap end of the market has seen solid (positive) forecast revisions in the five major banks, CSL, Origin and Rio Tinto in particular. Robustness in the top 20 stocks (with some exceptions like Brambles) is enough to maintain a positive trajectory in ASX200 Industrials forecasts on aggregate given the significant market cap bias to the top 12 stocks that represent half the market. However it does mask weakness in small-caps.

Our early predictions for reporting season

We think the August reporting season will follow the trends of the two previous. We expect:

- Robust large-cap performance, largely in-line with expectations for modest EPS growth.
- Misses to be punished severely given prevailing market valuations; and most notably,
- A repeat of last reporting season where Resources companies positively surprised on reported cashflows and dividends.

Points to note in Resources

- Commodity prices have corrected, but are still either in-line or above analyst forecasts.
- The miners' rhetoric around 'capital discipline' and 'value over volume' is unchanged (i.e. less capex and higher free cash).
- RIO and BHP themselves have flagged upside risk to dividends, which is all the more pertinent for BHP which is trying to fend off an increasingly antagonistic activist shareholder. We suggest up-weighting in Resources into August. Seasonal weakness has provided that opportunity.

Where is the best / positive EPS momentum since last reporting season?

- **Industrials:** Computershare, CSL, Origin Energy, Amcor, Imdex, A2 Milk, Lovisa, Boral, Henderson
- **Resources:** Rio Tinto, South32, Origin Energy, Woodside

Australian shares display material seasonal weakness in May-June, propagating the old investing adage 'Sell in May and go away'.

There are several plausible contributors:

- Seasonal commodity weakness
- Selling to offset taxable income ahead of EOFY
- Selling to clean up portfolios ahead of EOFY (in Australia)
- Uncertainty around the Federal budget

We highlight our best buys and stocks on our radar below.

Happy to buy

Bapcor*, Orora*, APN Outdoor, Aveo Group

Resources in accumulation territory

BHP Billiton, Oil Search*, OZ Minerals, South32, Rio Tinto

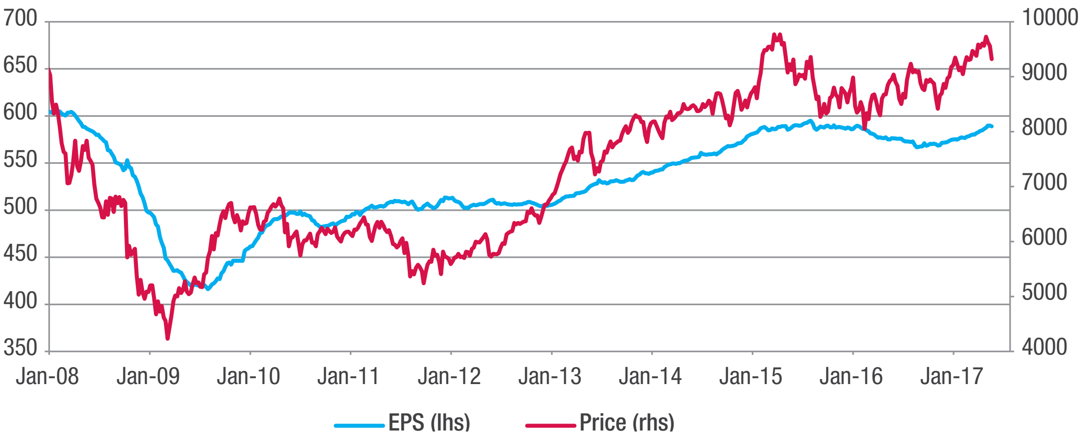
Favoured Industrials on a pullback

Computershare, Westpac*, Challenger, Macquarie Atlas Roads, Ramsay Healthcare, Resmed*, Amcor, Qube, Speedcast, NextDC, PWR, Midway, Aventus

* High Conviction Stock

ASX200 Industrials – Forward 12-month EPS vs Price

Resilience in forecasts for the ASX20 explains why the total market aggregate remains robust.



Source: FactSet

Fixed Interest – S&P ratings actions – Listed AT1 security implications

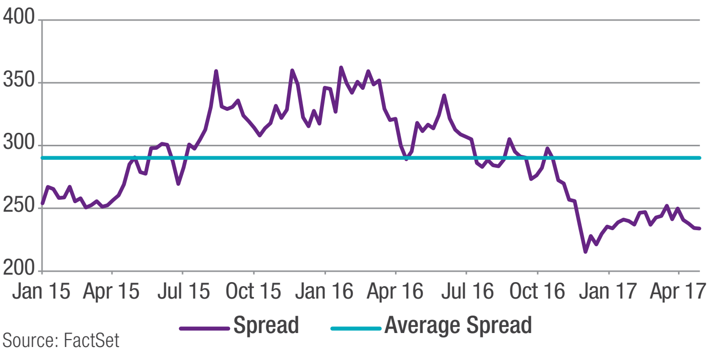
Standard & Poor's (S&P) recently downgraded its ratings on 23 Australian financial institutions by one notch due to concerns over increased residential property prices and the higher levels of private sector debt. The major banks (ANZ, CBA, NAB and WBC) had their senior long-term credit ratings affirmed at 'AA-' due to the expectation that the Australian Government would provide timely financial support. The outlook for the major banks remains Negative.

At the same time, the credit ratings on non-deferrable subordinated debt and hybrid securities were lowered by one notch. While the ASX Additional Tier 1 (AT1) securities do not have credit ratings that are made available by S&P to retail investors, they do provide credit ratings to institutional investors. Following the one notch downgrade, these securities are now rated 'BB+' having fallen from 'BBB-' which now results in them being deemed "sub-investment grade". That said, we remain comfortable with these securities from a credit perspective and note that there remains significant common equity tier 1 capital above the 5.125% trigger level. We also maintain that these securities, where consistent with investor objectives, can form part of a well diversified fixed interest portfolio which is supplemented by senior bonds and term deposits.

There has been some speculation that the one notch downgrade on these instruments may cause institutions to exit their positions in these securities. While there has been increased institutional involvement in the recent security issues, it remains limited and the bulk of the registers sits with retail investors. We understand that those institutions participating in the space have flexible investment mandates and they are not generally constrained to holding only investment grade instruments.

Given significant redemptions in the ASX listed space so far this year, and a further A$5.5bn of scheduled redemptions, we expect investor demand will remain strong which will likely result in security prices remaining elevated. We view the broader AT1 security market as fully priced and don't expect trading margins to move materially tighter from current levels. The chart below shows the average AT1 security trading margin (spread) vs the Australian iTraxx index (we use the iTraxx as a proxy for Australian corporate credit). The premium over the iTraxx has declined significantly over the past 12 months as the chase for yield has seen the outperformance of more subordinated instruments given the higher absolute returns offered.

Chart Average AT1 security trading margin (spread) vs the Australian iTraxx index



Source: FactSet

Healthcare – budget beneficiaries

Sonic Healthcare

'A net overall positive'

- **Reintroduction of Medicare Benefits Scheme (MBS) indexation** – provides some upside with GP and specialist consultations from July 2018, specialist and allied health procedures from July 2019, Diagnostic Imaging (DI) from July 2020 and no changes in pathology. It didn't knock-back our assumption that indexation would be re-linked to the Department of Finance wage cost index, which rose 1.9% in CY16 so this equates to a cA$5m earnings gain for Sonic over the next several years.
- **Bulk Bill Incentive (BBI)** – removal of the proposed MYEFO 2015/16 cuts to pathology and DI BBI, linked to indexation for GPs from July 2017 is positive for Sonic, but the company expects little earnings impact as it never believed the proposed changes would be approved by the Senate.
- **Pathology collection centre rents** – not addressed specifically in the budget, however, the Department of Health set aside cA$18m over four years to strengthen compliance in pathology approved collection centres. While there is little detail on exactly how this will work, likely requiring reinterpretation of the legislation around the deregulation of collection centre licenses, management believes the extra spend will be used to hire staff to ensure better licensing regulation and compliance across the industry. Noted that rent growth has 'plateaued' in recent times so the days of exorbitant rents appear over. While rent containment remains a work-in-progress, there is some hope for rents to return to sensible levels.

Primary Healthcare

'Good to have some Government tailwinds'

- **Reintroduction of MBS indexation** – GP MBS indexation is cA$5m annual revenue impact which drops straight through but is likely less today and in the future with the company diversifying into non-MBS revenues and lowering average service fees under new GP contracts. We estimate the earnings impact to be between 1-3%.
- **Bulk Bill Incentive (BBI)** – re-indexing GP bulk billing incentive is unlikely to materialise into earnings this year. It's really a FY19 benefit with up to A$2m per 1% move in the wage cost index so a cA$4m earnings gain at current levels. Maintenance of BBI in pathology and DI, re-indexing in DI in 2020 and the Dental initiative (i.e. increase the two-calendar-year benefits cap from A$700 to A$1,000 for all children eligible for the Child Dental Benefits Schedule) are all positives as well. The company has indicated previously that a pathology/DI BBI would be a cA$50m hit but never assumed the pathology regulation would get through as it was deemed 'unworkable'.

Banks – the real cost of the levy

The announcement of the levy on the five big banks (ANZ, CBA, NAB, WBC, and MQG) in the Federal Budget took much of the limelight away from the details which came out during reporting season. The Commonwealth Government expects the 'major bank levy' to raise A$6.2bn of revenue over the forward estimates period. The levy will consist of an annualised 6bps charge on certain liabilities for each of the big five banks. If the budget estimates are correct, then we estimate that the impact of the levy on the major banks' annual cash earnings will be a hit of 4-5%. However, by our calculations and by the preliminary estimates disclosed by the four major banks, the government's A$6.2bn revenue estimate appears to be an overestimate. Based on the banks' preliminary estimates, we estimate the impact on FY18 cash earnings will be a hit of 2-4%. Our base case is that the banks will reprice assets and liabilities to mitigate this impact such that the net impact on earnings will be negligible.

Whilst the levy has dominated bank-related headlines, two key themes seen this reporting season should not be ignored: stronger-than-expected capital ratios; and benign asset quality.

On the first theme mentioned, Common Equity Tier 1 (CET1) capital ratios generally came in much stronger than expected. The banks appear to be happy to slow down loan growth to focus on improving ROE and strengthening the balance sheet. In the case of every major bank this season, we observed declines in total risk weighted assets, particularly because each of the majors continues to shrink their institutional loan books and continues to focus on risk weighted asset optimisation. Stronger balance sheets are providing support to the dividend outlook for the sector.

The dividend outlook is also receiving support from a benign asset quality environment. With the exception of ANZ, the cost of risk for the majors continues to hover at cyclically low levels. An improving outlook for NZ dairy exposures creates scope for provision releases in the next half.

ANZ continues to remain our least preferred major bank. ANZ's 1H17 result vindicated our view that consensus was too optimistic about ANZ's revenue and pre-provision profits. The market is now waking up to the weak underlying revenue trend in ANZ's business and is also increasingly realising that divestments announced to date are likely to prove to be decremental to EPS even after capital management initiatives are undertaken.

Westpac remains our preferred major bank as we believe it offers the best value at current share prices. While there has been increasing concern about housing-related risks, we continue to believe that home loan assets are generally more defensive than institutional and business lending exposures. We believe WBC's loan book is relatively defensively positioned with its skew to Australian home lending.

Estimate post-tax impact of levy

	Company's estimated annual impact post-tax (A$m)	Morgans' corresponding estimated annual impact based on financial position at mid-FY18F (A$m)	Impact as % of FY18F cash earnings	Share price movement since close on 8th May (adjusted for ex-div impact)
ANZ	240	252	3.8%	(5.8%)
CBA	220	226	2.2%	(6.0%)
NAB	245	257	3.7%	(7.2%)
WBC	260	273	3.1%	(8.0%)

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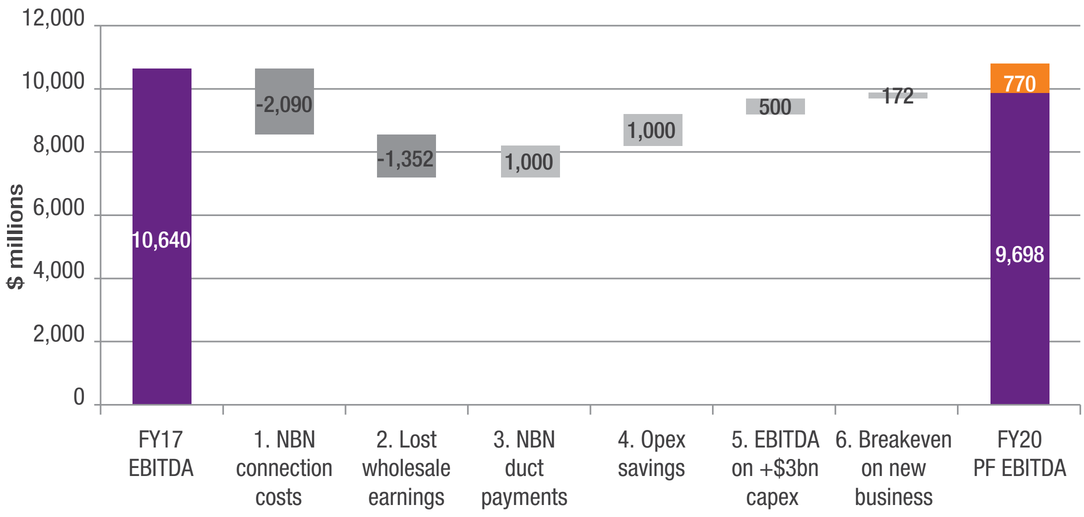
Telco – planning for the future under an NBN

The National Broadband Network (NBN) has changed the competitive landscape dramatically and by June 2017 the NBN will account for 30% of all household fixed line internet connections, which makes the implications hard to ignore going forward. Telstra has been progressively releasing the implications to its earnings and details of how it is looking to replace the earnings gap. We believe the most eloquent, albeit overly simplistic, way to explain this earnings transition is in the chart adjacent which shows that Telstra will lose ~30% of its EBITDA but is taking steps to limit this to around a 7% (or A$770m) loss, assuming everything goes to plan.

We also need to point out that Telstra gets one-off compensation to the tune of A$4bn (after tax and discounted at 10% back to 2010), which is not factored into this chart. This extra capital (after paying for one-off items like restructures and cost to connect to the NBN) can be used to replace this missing 7% via building out existing earnings streams, buying more earnings streams and/or buying back its own shares. We do expect Telstra will emerge in a strong position post 2020 and believe that the dividend is maintainable but it's going to be a messy few years to get there.

Telstra earnings transition to FY20



Note: Assumes latest recent NBN rollout strategy (June 2017) – subject to change.

Key assumptions in the chart above which get us to the end position are as follows:

- We assume Telstra has 50% NBN market share (broadly similar to current levels). This equates to 4.1m subscribers for which Telstra pays A$43 per month to the NBN in access costs.
- We assume Telstra loses half of its A$2.6m wholesale EBITDA (since 52% of Telstra's wholesale subscribers are fixed subscribers and many of these customers will buy directly off NBN rather than Telstra).
- NBN payments to Telstra will reach ~A$1bn per annum as NBN rents ducts and other infrastructure off Telstra to put their NBN cables in.
- Telstra is aiming to remove A$1bn in operating costs by 2020 as it simplifies the business and no longer has to support the last mile of copper.
- Telstra has flagged an additional A$1bn per annum of capex over the next three years and it expects this additional capex will generate around A$500m in additional EBITDA (from new revenue and business improvements).
- Telstra has invested less than A$1bn in new businesses (including Telstra Health, Telstra Software Group and Telstra Ventures), which currently cost Telstra A$172m in EBITDA in FY17. It expects these businesses to reach EBITDA breakeven by 2020, which means they will no longer have a negative impact on EBITDA. It won't be an easy task but Telstra has a solid plan to restructure and reposition the business for a post NBN world. This, combined with deploying the A$4bn in one-off capital (to build, buy and buy-back), should mean Telstra's dividend is sustainable in a post NBN world.

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

Recent data suggest that the global economy is strengthening, which is supportive of growth assets, although on current elevated valuations there is little room for earnings disappointment.

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 break out of this seasonally weaker period.

In the middle of what is a traditionally weaker period (May-June) for markets, we make two changes removing Macquarie Atlas Roads (**MQA**) given the strong price performance and uncertainty arising from the sell-down by one of MQA's co-investors in the APRR toll road in France expected 2H17. We also remove Beacon Lighting (**BLX**) due to the recent stark reduction in consumer spending and sentiment in the Retail sector.

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

Morgans' High Conviction Stocks

ASX 100

	Ticker	Price	Price Target	FY18 Dividend Yield	FY18 Gross Yield	PE 12mf (x)	12m TSR
ResMed	RMD	$9.65	$10.23	2.0%	2.0%	24.7	8%
Orora	ORA	$2.82	$3.22	4.2%	4.8%	16.5	19%
Westpac	WBC	$30.29	$38.00	6.3%	8.9%	11.6	34%
Oil Search	OSH	$7.09	$10.22	2.2%	2.2%	19.1	46%

Ex-100

	Ticker	Price	Price Target	FY18 Dividend Yield	FY18 Gross Yield	PE 12mf (x)	12m TSR
SpeedCast	SDA	$3.94	$4.72	2.6%	3.7%	13.3	24%
Bapcor	BAP	$5.28	$6.38	3.2%	4.6%	17.0	25%

Source: FactSet Data as at 2 June 2017

Queensland

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Gold Coast	+61 7 5581 5777
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Kedron	+61 7 3350 9000
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Noosa	+61 7 5449 9511
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Coffs Harbour	+61 2 6651 5700
Gosford	+61 2 4325 0884
Hurstville	+61 2 9570 5755
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Neutral Bay	+61 2 8969 7500
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