July 2017

Investment Watch

A return to growth

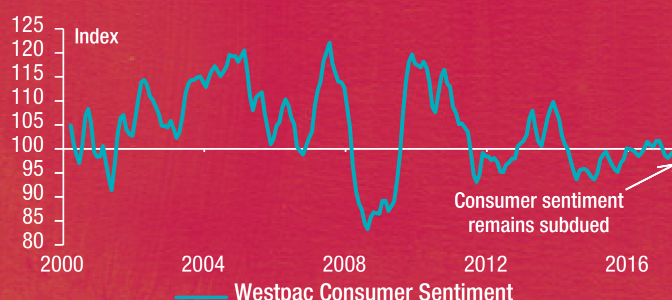
The outlook for growth appears increasingly positive for Europe and the US. Macro indicators of employment, corporate profits, consumer sentiment, industrial production and inflation are all supportive of an improved outlook for growth. We explore the drivers of a synchronised US and Euro Area recovery and provide our outlook for growth on page 2.

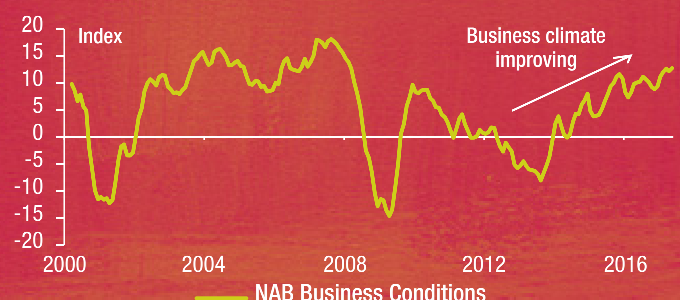
Over the short term we see more downside risks to the AUD against the USD and Euro. The jury is still out on whether the domestic economy will break out of its below-trend period of economic growth, and in the absence of any meaningful fiscal or monetary policy drivers, the August reporting season is set to be critical to assessing corporate health. In this edition we highlight stocks that benefit from a global recovery on page 3. We also look at the health of the consumer and whether retailers are likely to see a reprieve in the second half of the year on page 4.

Trading at 15.3x PE (12m forward earnings), the Australian market is not as elevated as other markets around the world. This leaves some capacity for a valuation re-rating if we see upside to economic growth however the likelihood is that there will have to be clearer evidence of growth picking up from current levels to underpin larger equity gains.

On 22 June, Morgans hosted an AgriFood Conference in Sydney. In an increasingly important part of the Australian economy, the conference provided an opportunity to hear from some of Australia's best AgriFood companies. We summarise the key themes from the day on page 6.

Business confidence remains upbeat but consumer sentiment still lags





Source: Factset

Important disclosures regarding companies that are the subject of this report and an explanation of recommendations can be found at the end of this document. Morgans Financial Limited ABN 49 010 669 726 AFSL 235410 A Participant of ASX Group A Professional Partner of the Financial Planning Association of Australia Level 29 123 Eagle Street Brisbane QLD 4000 Australia Phone 1800 777 946

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Economics – the Fed and the ECB

The US economy

The US Bureau of Economic Analysis has revised up first quarter GDP from 0.7% to 1.2%. We think the US economy will grow by 3% in the second quarter of 2017. This should slow in the third quarter to 2.9%. By the time the fourth quarter arises, growth in GDP should ease further to 2.5%.

Because of the weak first quarter, we think that growth for the full year will be 2.3%. This is stronger than the Federal Reserve estimate for 2017 of 2.2%. This relatively low GDP growth hides the emerging strength of the US economy. This emerging strength happens because of a surge in investment. There are two main areas where this surge in investment is occurring.

Mining and petroleum

Weak oil prices in 2015 and early 2016 saw a slump in investment in this sector. Investment in non-residential construction in the mining and petroleum area slumped by 30% in 2015. It slumped again by more than 40% in 2016. This slump in investment generated the weakness in the US economy in 2016 where growth declined to only 1.6%. The recovery in US oil prices from the second half of 2016 has seen a dramatic acceleration of construction in the sector.

Transport equipment

A stronger level of activity in the US economy is generating stronger demand for travel. This is particularly true for air travel. This increase in domestic activity generates an increase in demand in the US economy. After rising by only 2% in 2016, gross national expenditure should rise by 2.3% in 2017 and 2.5% in 2018. All of this adds up to GDP growth rising from 2.3% in 2017 to 2.7% in 2018. Our estimate for growth for the US economy of 2.7% in 2018 is way higher than the Federal Reserve's estimate of 2.1% in 2018.

The Euro Area

In his speech on 8 June 2017, the President of the European Central Bank Mario Draghi confirmed that quantitative easing would continue. Regarding non-standard monetary policy measures, he confirmed that net asset purchases would continue at the current rate of 60 billion Euros per month and will continue until the governing council sees a sustained rise in inflation to a target of below but close to 2%, over the medium term.

The Euro Area economy is looking better. It grew by 0.6% in the first quarter of 2017 after rising by 0.5% in the final quarter of 2016. He said that survey results continue to point to solid broad-based growth. In particular, recovery in investment continues to benefit from very favourable financing conditions and improvements in corporate profitability. He said that staff projections by the European Central Bank see GDP rising by 1.9% in 2017, by 1.8% in 2018 and by 1.7% in 2019.

The ECB staff see the Euro Area inflation rising by 1.5% in 2017. This eases to 1.3% in 2018. It then recovers to 1.6% in 2019. This weakness in inflation is caused by a stable outlook for oil prices.

Draghi has always argued for, what Australians call, micro economic reform. He stated that economic growth prospects continue to be dampened by the slow implementation of structural reforms, in particular in product markets. This means he wants trade barriers within the Euro Area, caused by individual country regulation, to be reduced much more aggressively.

The big problem the Euro Area had in 2012 and 2013 was a slump in business lending. Draghi noted that this has been improving since 2014. He said that growth in loans to non-financial corporations increased by 2.4% in the year to April 2017.

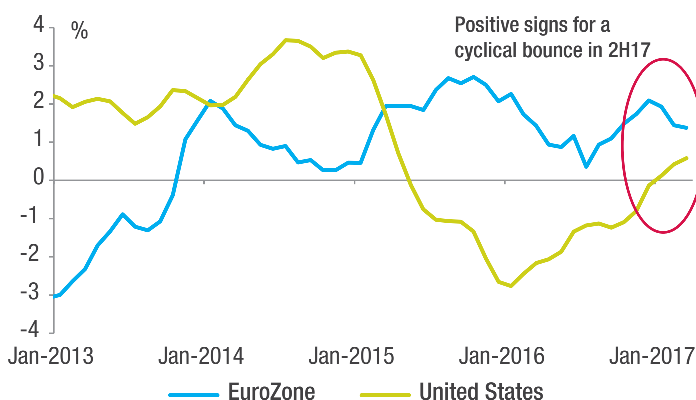
Conclusion

Unlike 2007, the US and Europe are now at very different points of their own business cycle. The US is approaching the end of its business cycle. Strong growth and low unemployment mean the Fed must continue to tighten.

In Europe, growth is only now beginning to accelerate. There is still a very large pool of unemployed that needs to be absorbed. The need for more employment means that the European Central Bank must continue to provide stimulus for the Euro Area economy.

When the US economy finally does slow down, it will be in the context of a strongly growing European economy. World growth is no longer synchronised.

Economic output indicator pointing to better conditions (Industrial Production)



Source: Factset

Equity strategy – a return to global growth

The outlook for growth is looking increasingly positive in Europe and the US. Macro indicators of employment, corporate profits, consumer sentiment, and industrial production inflation are all supportive of an improved outlook for global growth.

While some in the market believe that low and stable inflation will remain for the foreseeable future, we are of the view that the factors underpinning the global economy will again give rise to improving reflation expectations. It was only less than 12 months ago that the market brushed off the idea despite a credible recovery in commodity prices and reduced credit stress in fixed income markets. We think we are at the point of another turnaround in inflation expectations.

- The Euro Area economy is looking better. It grew by 0.6% in the first quarter of 2017 after rising by 0.5% in the final quarter of 2016. Survey results continue to point to solid broad-based growth. In particular, recovery in investment continues to benefit from favourable financing conditions and improvements in corporate profitability. Projections by the European Central Bank see GDP rising by 1.9% in 2017, by 1.8% in 2018 and by 1.7% in 2019.
- The United States economy continues to improve. The US Bureau of Economic Analysis of the Department of Commerce has revised up the first quarter of GDP from 0.7% to 1.2%. We forecast the US economy will grow by 3% in the second quarter of 2017 and end up growing by 2.3% in 2017. We see a significant turnaround in domestic demand particularly from the mining, petroleum and transport sectors.

If a recovery in growth remains in place in the major economies, inflation expectations should not move much lower from current levels.

Opportunities abroad

Companies in the ASX 200 currently source 66.3% (78% ex-resources and healthcare) of revenue from Australia (FactSet GeoRev). While the headline number indicates a large home bias, a large proportion (29%) of companies have significant revenue (>20%) generated from offshore. We have noted the high investor home-bias to domestic equities in the past (International Strategy – Global Compass) and the benefits of diversification; we highlight ASX listed stocks that offer investors leverage to improving economic growth offshore below.

Non-negligible downside risks remain

There are, however, non-negligible downside risks to this outlook, such as uncertainty around US fiscal policy and regulatory tightening in China leading to negative growth surprises. Moreover, we remain cautious about the long-term outlook for trade growth. The current upturn is cyclical, but structural issues such as increasing protectionism, a slowdown in investment and uncertainty about the regulatory environment remain.

For more information refer to Playing a Synchronised US and Euro Area Recovery published 27 June 2017.

Preferred offshore earners

Company	Comments
Corporate Travel Management (CTD)	There is some upside to consensus from improving conditions; however, the greatest upside to consensus is further accretive acquisitions. Given the company over raised at least another one is expected in FY18 and likely in the US or EU. The US represents 36% of FY18 EBITDA and EU is 20%.
Incitec Pivot (IPL)	There is potential upside to consensus if US explosives earnings recover faster than expected due to stronger end-market demand from a recovery however analysts are assuming reasonable growth at this stage. IPL already has a low tax rate at c24% in FY18 but we would expect this to fall on a cut to US corporate tax rates.
Domino's Pizza (DMP)	DMP generates around 29% of its EBITDA from Europe. Therefore an improving economy is positive, although perhaps less leverage than other categories given the low transaction value of the product.
Orora (ORA)	ORA provides leverage to an improving US economy as demand for packaged goods picks up. ORA generates around 50% of revenue from North America and will benefit from a cut in the corporate tax rate.
Amcor (AMC)	AMC provides leverage to improving developed markets; Western Europe and US represent one-third of revenue respectively. The potential for tax cuts will improve profitability in both regions.
Macquarie Group (MQG)	About one-third of MQG's earnings come from the US and Europe respectively, so it has reasonable leverage to a recovery in these regions.
SpeedCast (SDA)	SDA provides leverage to the Trump Administration's pro-growth policies in Oil and Gas given 45% of its revenue is leveraged to this sector following the recent acquisition. It is also a beneficiary of increased data demand on cruise liners. 87% of SDA's revenue is in USD.
BT Investment Management (BTT)	Around 18% of BTT's funds under management is deployed in Europe and 13% in the USA. In broad terms, an improving economy in these regions would benefit company earnings and in turn equities market performance. In addition, BTT could benefit from increased investor appetite and receive increased funds flow into European funds.
ALS Limited (ALQ)	Provides significant leverage to cyclical minerals recovery which is already underway. Profitability is returning from cyclical lows yet its PE is trading in line with listed peers. There is potential for its five-year strategic plan to deliver further margin and revenue benefits.
Macquarie Atlas Roads (MQA)	MQA is highly leveraged to the growing road traffic trends in France and the USA. The company pays no tax in the USA at present but will long term. If the USA cuts the tax rate to 20% then it adds 5 cps to our valuation. If France cuts its company tax rate to 25% (currently legislated to reduce from 33% to 28% in 2020) then our valuation increases 25cps.

Consumer staples and retail – Amazonian risk or a sector on sale?

Retailers continue to be impacted by difficult trading conditions, with a raft of earnings downgrades across the sector in recent months. Here are the issues facing the consumer currently:

- out of cycle mortgage rate hikes by the banks
- potential pass-through of the banks' bank levy
- a cooling housing market (and subsequent impact on perceived 'wealth')
- increasing power/utility costs

This has all led to reasonably weak consumer sentiment and therefore spending.

The state of the housing market is critical in our view, as it has been one of the few tailwinds supporting the Australian economy and therefore spending in recent years. Undoubtedly, some of the heat has come out of the market (especially in relation to pricing), however this had to happen and we expect reasonably solid conditions to persist from here, supported by historically low interest rates.

In the background, the retail sector has de-rated significantly on fears regarding Amazon's potential entry into Australia. We have now reached a point where investors and market analysts are now trying to estimate the potential impacts (market share and margin losses) for businesses, particularly in the key categories at risk such as electronics, sporting goods/ equipment, homewares, clothing and toys.

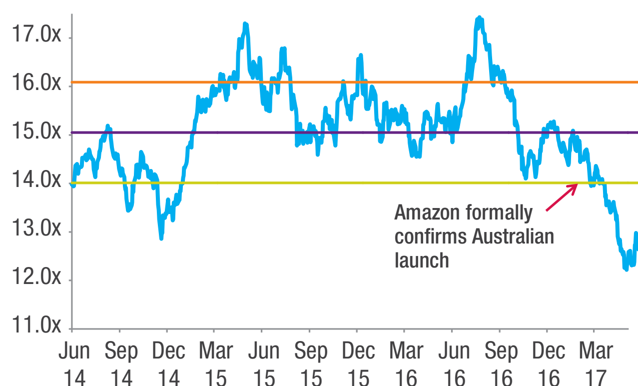
While there will obviously be some impact to Australian retailer earnings, this is still largely an unknown at this point (and this is one of the key reasons the market has placed lower earnings multiples on the sector). We believe that periods of noise and volatility such as these present opportunities for investors who are willing to go 'bargain hunting' for high quality names that have defensible brands and established market positions. While Amazon has one of the best business models in the world, just like has occurred overseas, we believe the strong/ category killer retailers will survive and potentially even prosper in a post Amazon world (unfortunately benefiting from the likely demise of small/ independent retailers).

For supermarket operators, the big news recently has been Amazon's acquisition of Whole Foods Market in the US. This is by far Amazon's largest acquisition to date and shows it is serious about growing its grocery capabilities. Whole Foods' 450+ store network also gives Amazon a much stronger physical presence across the US. Having this national presence gives Amazon many more consumer touch points and these store locations can act as micro-fulfilment centres over time where goods can be dispatched to consumers locally, allowing for even faster delivery times.

What does this mean for Australian supermarkets? While it will take some time for Amazon to bed down its grocery strategy following the Whole Foods acquisition, Amazon's arrival in Australia will almost certainly mean higher competition for the Australian supermarket sector. Woolworths, Coles and Metcash are already seeing intense competition from Aldi and to a lesser extent Costco. Kaufland/Lidl has also flagged its intention to enter Australia over the next few years so life is not going to get any easier for the incumbents. This will put further pressure on earnings and margins and as such, we don't see any compelling reason to be exposed to the sector at this stage.

Overall, we remain cautious on the consumer and the retail sector more broadly. However, we also believe, as always, there are opportunities amongst the 'noise'.

S&P ASX 300 / Consumer Discretionary PE NTM – Last 3 years



Source: Morgans, FactSet

AgriFood – Morgans Conference

On 22 June, Morgans hosted an AgriFood Conference at its offices in Sydney. The conference provided a great opportunity to hear from some of Australia's best AgriFood companies, as well as provide an introduction to the sector's emerging listed companies. We had presentations from Elders (ELD), GrainCorp (GNC), Midway (MWY), Naomi Cotton Co-op (NAM), Capilano Honey (CZZ), Beston Global Food Company (BFC) and Bubs Australia (BUB).

ELD highlighted its strict ROC discipline which is now ingrained across the entire organisation. GNC outlined the company's strategic focus post growth projects which involves deleveraging the balance sheet and then pursuing additional growth opportunities and/or capital management. MWY spoke of the positive industry fundamentals which should support a rising woodchip price over coming years. CZZ detailed the company's growth strategy which should position it well to resume earnings growth in FY18. NAM discussed the co-operatives restructuring plans which are underway and noted it is well placed to take advantage of the improved seasonal outlook. BFC said the company's significant investment in FY17 should provide a strong foundation for future growth. Finally, BUB highlighted the impressive distribution agreements the company has announced since listing, both domestically and offshore.

Of the companies we cover, Morgans' key picks of the AgriFood sector are **CZZ** (Add) and **MWY** (Add). We are buyers of ELD (Add) on a pullback given its recent outperformance and we are happy holders of GNC (Hold). For BFC (not covered), we see newsflow around new distribution agreements and realising value in its portfolio as a potential catalyst. Newsflow around distribution agreements is also a catalyst for BUB (not covered). For NAM (not covered), a successful restructuring of its corporate structure should narrow its discount to NTA.

For more information refer to Morgans AgriFood Conference published 27 June 2017.

Table of key picks

Stock	Price	Price Target	PE (FY18)	EPS Growth (FY18)	Dividend Yield
Capilano (CZZ)	$15.81	$18.95	13x	10%	3.1%
Midway (MWY)	$2.52	$3.00	10x	14%	8.1%

Sources: Morgans, IRESS

Financials – global fund managers performing strongly

Global stock markets have generally outperformed the local ASX over the past 12 months, led by the Dow Jones and UK's FTSE both up over 20%. On the back of this strength, share price performance has been strong for fund managers with an offshore focus – Magellan Financial Group, BT Investment Management and Janus Henderson.

In late May, Westpac sold down a 19% stake (retaining a 10% holding) in **BT Investment Management** (BTT) at A$10.75ps. BTT recently posted a strong first half result, benefiting from stronger markets and a rebound in funds flow into UK and European funds. BTT has performed strongly post the sell-down from Westpac, up around 12% including dividends. Whilst the stock has headed close to our valuation, BTT has very broad exposure to Global markets (including the US, UK and Europe) which positions the business to attract further funds and benefit from any medium-term growth rebound in the European region. Our Economics and Strategy team are expecting improving economic growth in the Euro Area and we expect BTT will be a beneficiary of this over the longer term.

Magellan Financial Group (MFG) has also performed very strongly, with both its Global Fund and Infrastructure Fund returning to outperformance (of benchmarks) over recent times. This has put the group back in performance fee territory and should see solid net fund inflows continue from retail investors. We believe MFG is a very strong long-term structural growth business, however the stock has jumped around 25% in recent months and more active investors could now look to lock in some profits.

Insurers and diversified financials – strong investor appetite

Broadly the insurance and diversified financial sectors continue to remain fully valued at present in our view.

- The Suncorp (SUN) investor day provided some positive news during the quarter, with management pointing to continued ~5% rate increases in key home and motor insurance classes, with SUN now expecting to hit its 12% insurance margin target in 2H17. We expect this positive pricing momentum to flow into FY18 benefiting both SUN and IAG, but we still see SUN as fair value and IAG as expensive at current levels.
- QBE (QBE) downgraded FY17 guidance in late June on higher emerging market (EM) claims and also topped up EM claims provisions. While problems continue to emerge for QBE, we used the opportunity to move the stock to an Add recommendation. We think the ~10% QBE share price fall on the day was overdone, with QBE now looking cheap on an FY18F PE of ~11.5x.
- Link's (LNK) acquisition of Capita's Asset Services division was the biggest event in the quarter. While the acquisition is large (approximately half of LNK's market capitalisation), it does appear a strategic fit on face value in our view, with double digit EPS accretion expected after efficiency benefits.
- Health Insurers, Medibank Private (MPL) and NIB (NHF), have seen recent share price weakness following industry statistics showing a slowdown in the recent favourable claims trends, which had benefited both stocks.
- On Macquarie Group, its FY17 result beat guidance, however revenue pressures are clearly emerging as the cycle peaks.

Outside of QBE, our other sector ADD recommendations remain **AMP** (AMP) and **Kina Securities** (KSL). We continue to believe AMP will outperform over the next year as more stable results highlight the worst is over post its recent life insurance issues. KSL, trading on ~8x FY17F PE, continues to offer a long-term structural growth story, undervalued by the market, in our view.

For more details on our recent QBE upgrade refer our recent note Value emerging on FY18 forecasts.

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convenience RETAIL REIT

Convenience Retail REIT Initial Public Offer

Convenience Retail REIT is being established to invest in Australian convenience retail commercial property, leased to leading national and international businesses which operate petrol stations, fast food outlets and related convenience based consumer offerings

Convenience Retail REIT will be an Australian Real Estate Investment Trust (AREIT) listed on the ASX and has been designed to deliver a high, reliable and growing cash income stream, as well as the potential for capital growth over time.

Convenience Retail REIT has appointed APN Fund Management Limited (Manager),a wholly owned subsidiary of APN Property Group (ASX:APD), as manager of the portfolio.

Offer price: $3.00

Offer size: $162.2 million

Offer close: Friday, 21 July 2017

Offer website: www.crreit.com.au

View prospectus: www.morgans.com.au/convenience-retail-ipo

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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

A fresh start

A new financial year presents an opportunity for investors to take a fresh look at portfolios. Ahead of the August reporting season, stocks that have had a difficult FY17 have an opportunity to make a fresh start, particularly if operating conditions improve over the course of the year as we expect.

This month we add **Australian Finance Group** (AFG) to the high conviction list.

AFG has been around since 1994 and has grown to become one of Australia's largest mortgage broking groups and one of the country's leaders when it comes in financial solutions.

An environment of increasing compliance and regulatory scrutiny for mortgage aggregators/brokers provides AFG with scope to attract more brokers to its network and expand market share. This is particularly the case given that AFG is owned independently of any lender, it has scale and a good technology platform.

We believe concerns regarding cuts to broker commissions stemming from the announcement of the major bank levy and concerns about the extent of softening housing activity as a result of macroprudential rules are overblown. This has resulted in AFG offering good value and an attractive dividend yield (8.2% FY18F).

We removed **Orora** and **Speedcast** from the list this month.

For more detail refer to our latest High Conviction Stock list published 4 July 2017.

Morgans' High Conviction Stocks

ASX 100

	Ticker	Price	Price Target	FY18 Dividend Yield	FY18 Gross Yield	PE 12mf (x)	12m TSR
ResMed	RMD	$10.12	$10.23	1.8%	1.8%	26.7x	3%
Westpac	WBC	$31.12	$38.00	6.3%	8.9%	11.6x	31%
Oil Search	OSH	$6.70	$10.22	2.2%	2.2%	19.0x	53%

Ex-100

	Ticker	Price	Price Target	FY18 Dividend Yield	FY18 Gross Yield	PE 12mf (x)	12m TSR
Bapcor	BAP	$5.44	$6.38	3.1%	4.5%	17.4x	22%
Australian Finance Group	AFG	$1.27	$1.65	8.0%	11.5%	9.6x	41%

Source: FactSet Data as at 5 July 2017

NOOSA MINING CONFERENCE
19-21 July 2017

Book now. Places are limited. Morgans clients attend for free.
www.noosaminingconference.com.au/register

Some of the keynote speakers this year include:

Dr Chris Burns – Senior Battery Engineer at TESLA, CEO and Founder of Novonix
Dr Ed Buiel – CEO and Founder of Coulimetrics
Dr Ian Runge – Founder of RPMGlobal
Todd Harrington – Resources Investment Commissioner for QLD
Michael Knox – Director of Strategy and Chief Economist at Morgans

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