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August 2017

Investment Watch

Focus on reporting season

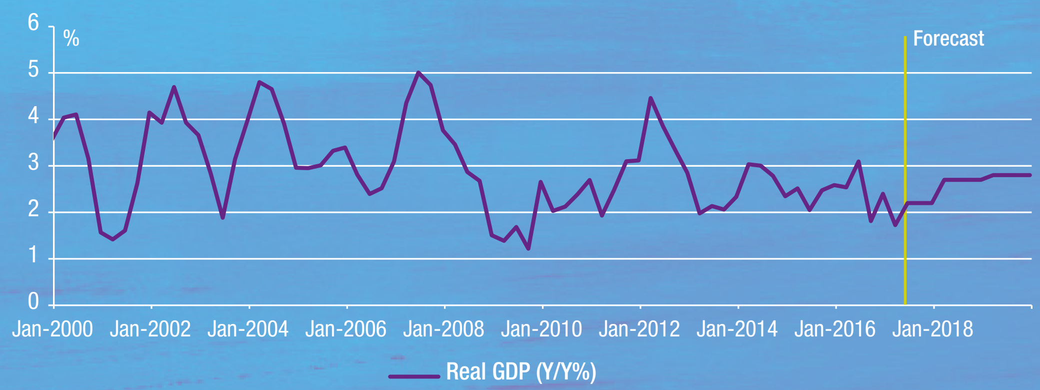
News on Central Bank policy, inflation and interest rates takes a back seat in August. Focus turns to corporate performance and the resilience of earnings in the midst of rising energy costs, a subdued consumer and higher funding costs. The ASX200 is poised to break the 2-year earnings drought (EPSg: FY17 +13%, FY18 +6%) though there remains many unanswered questions about the sustainability of the earnings recovery. We think upbeat outlook commentary will be necessary to give investors comfort against elevated valuations (ASX200 12mf PE: 15.4x).

The Australian economy continues to grow, but at below trend rates. Previously, the slower than usual growth was due to the sluggishness in the non-mining economy and the inability to offset the wind-down of the resources investment boom. More recently, the slower growth has been due to the cautious household sector offsetting more-optimistic spending plans in the business sector.

Forward-looking indicators of business activity continue to indicate a broad expansion in activity. After a prolonged period of cost-out and consolidation, it is encouraging to see a sustained pick-up in business conditions and sentiment which we expect to translate into an improvement in earnings. The translation of improving 'soft' survey data into earnings growth is necessary to support the high valuations commanded by the market. Falling payout ratios suggest that perhaps corporate Australia is finally ready to revive capital expenditure and investment in growth.

This month's edition explores the impact of energy prices on company earnings for the year ahead (Page 4), covers off on the all-important Banking and Resources sectors (Page 5), and takes a look at High PE stocks, looking at risks around some market darlings (Page 6).

Australian GDP growth versus forecast



Source: Bloomberg Forecast

Contents

This edition we look at ...

The state of the Australian housing market has been a hot topic among the financial press. This month we encourage readers to view an interview with Chief Economist **Michael Knox** and Banks Analyst **Azib Khan**, who pick apart the key issues in this space – a must view for investors.

http://bit.ly/MorgansConversations

Economics – why the Fed must reduce its balance sheet

In her presentation to the Committee on Financial Services of the US House of Representatives in early July, Janet Yellen, Chair of the Federal Reserve said: 'The Committee intends to gradually reduce the Federal Reserve's securities holdings by decreasing its reinvestment of the principal payments it receives from the securities held in the system Open Market Account'. She went on: 'Our securities holdings will gradually decline'. She also said that the Committee would reduce the quantity of reserves in its balance sheet to a level 'appreciably below recent levels but larger than before the financial crisis'.

Why does the Federal Reserve need to reduce its balance sheet? We can understand the reason by looking at the path of the Fed Funds rate shown below. We have shown the reduction in the Fed Funds rate that the Federal Reserve has had to make in each of the past four recessions.

To combat the recession of the early 1980's the Federal Reserve cut the Fed Funds rate by 5.75% from 11.75% in August 1984 to 6.0% in August 1986. The next time the Federal Reserve needed to cut rates was from May 1989 when the Fed Funds rate stood at 9.75% to September 1992 when the Fed Funds rate stood at 3.0%. The total rate cut at this occasion had been 6.75%.

It was not until the beginning of the next decade when the Federal Reserve had to cut rates again. The Federal Reserve cut rates from August 2000 when the Fed Funds rate stood at 6.5% to June 2003 when the Fed Funds stood at 1.0%. The total rate cut on this occasion was 5.5%.

The final rate cut on our chart is shown as a result of the Great Recession. The Federal Reserve cut rates from August 2007 when the Fed Funds rate stood at 5.25% to December 2011 when the Fed Funds stood at 0.07%. The total rate cut on this occasion had been 5.18%. What makes this recession different is that the cut in the Fed Funds rate was followed by quantitative easing.

What do we learn from looking at these numbers? The sizes of the first three rate cuts on the chart are 5.75%, 6.75% and 5.5%. The average of these three rate cuts is 6%. This means that in these three US recessions, the Fed had to cut the Fed Funds rate by an average of 6% to generate enough stimuli to re-start the US economy.

If we include the final rate cut of 5.18% in our average, then the average Fed Funds rate cut that the Fed needs to undertake to generate enough stimuli to re-start the US economy is 5.8%. We can see that the average stimulus is in the range of 5.8% to 6%.

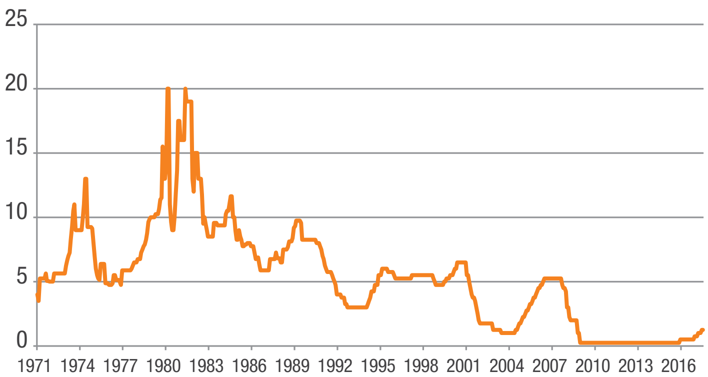
The problem with this in the current economic cycle is that the Fed expects the Fed Funds rate to stabilise by 2019 in a range between 2.5% and 3.5%. The median expectation is that the Fed Funds rate will peak in this cycle at 3.0%.

The National Bureau of Economic Research, which tabulates US recessions, tells us that the longest expansion in the US economy was the ten year period from 1991-2001. Today's economy has been expanding since 2008, meaning that this expansion is already the second longest in US history. It is reasonable for us to suggest that the next US recession is no more than five years away. Indeed the data since 1785 would suggest that the chance of such an event does approach 100%.

How would the Federal Reserve handle such a recession? If it starts from an interest rate of 3%, and has to cut rates by 6%, then clearly this is impossible. What is more likely is that rates will fall from 3% to 0%, followed by a period of quantitative easing. Quantitative easing means that the Federal Reserve must again expand the Federal balance sheet.

Back in 2006, the Federal Reserve balance sheet stood at a level of around 6% of GDP. The first round of quantitative easing followed by further rounds of quantitative easing lifted the size of the Federal Reserve balance sheet by 2014 to around 25% of GDP. We think that the Federal Reserve needs to reduce the balance sheet down to around 15% of GDP to have sufficient room for another round of quantitative easing. This means that it needs to start reducing the Federal Reserve balance sheet now.

US Fed Funds Rate



Source: Factset

Equity strategy – reporting season preview

An end to the earnings drought

FY17 reporting season kicks off in earnest mid-August and according to the latest IBES consensus earnings estimates, EPS growth for the S&P/ASX200 is forecast at 13.0% in FY17, slightly down from 13.6% at the end of 1H17. Pleasingly this would still mark the end of the earnings recession after two straight years of contraction.

We are confident that the improvement in the economic outlook will translate to earnings over the next 12-18 months so long as the positive conditions are reflected outside of Resources. With this in mind, we think that outlook commentary and how management chooses to deploy capital may be as important as reported numbers.

The growth versus value conundrum

The prospect of policy gridlock in the US and low levels of global wage inflation have again resurfaced disinflationary fears. This has prompted investors to seek safety in the quality and yield trades that have been so profitable for many over the past two years. Valuations therefore remain extended and the divergence between 'growth' and 'value' stocks has again widened. High valuations make for high expectations. We are wary of high PE stocks with even the slightest earnings risk (**CSL**, **Dominos Pizza**, **Cochlear**) – as demonstrated through the May 'confession' season, stocks that miss the mark continue to underperform. The PE divergence also presents opportunities in overlooked areas of the market where we see earnings upside potential (**Lovisa**, **JB Hi-Fi**, **Collection House**).

Turning 'soft' data into earnings

While a lot has been said of the weak growth in the Australian economy in Q1 2017, forward-looking indicators of business activity continue to indicate broad expansion in activity. After a prolonged period of cost-out and consolidation, it is encouraging to see a sustained pick-up in business conditions and sentiment which we expect to translate into an improvement in earnings. The translation of improving 'soft' survey data into earnings growth is necessary to support the high valuations commanded by the market. And falling payout ratios suggest that perhaps corporate Australia is finally ready to revive capital expenditure and investment in growth.

The pick-up in business confidence and a slower pace of negative earnings revisions mark a turning point for a cyclical upswing. We stand ready to accumulate quality cyclical names on weakness.

We highlight our key candidates that may surprise or disappoint at the result below.

Reporting season surprise and disappoint candidates	
Potential earnings surprise	Amcor, Reliance Worldwide, JB Hi-Fi, Lovisa, Webjet, ResMed, Bapcor
Likely to see positive Outlook Statements	Ramsay Healthcare, Healthscope, Collection House, Sirtex, EBOS
Potential for positive Capital Management	BHP, RIO Tinto
Potential earnings disappoint	Coca-Cola Amatil, Blackmores, Pact, Admedus
Possible soft outlook	Telstra, TPG, Cedar Woods, Mantra
Vulnerable high PE Stocks	Ansell, CSL, Cochlear, Domino's

For more information refer to our FY17 Reporting Season Preview published 24 July 2017.

Domestic energy – political gridlock but forward pricing easing

The increase in domestic electricity and gas prices has received plenty of press coverage. Power prices rose dramatically through to mid-2017 as a result of numerous factors, including a changing generation mix (more renewables, fewer thermal plants), increasing gas costs for gas-fired power generators, weather events, transmission constraints, and in Queensland increased demand as well as generation concentration. In addition, the market price of renewable energy certificates rose dramatically.

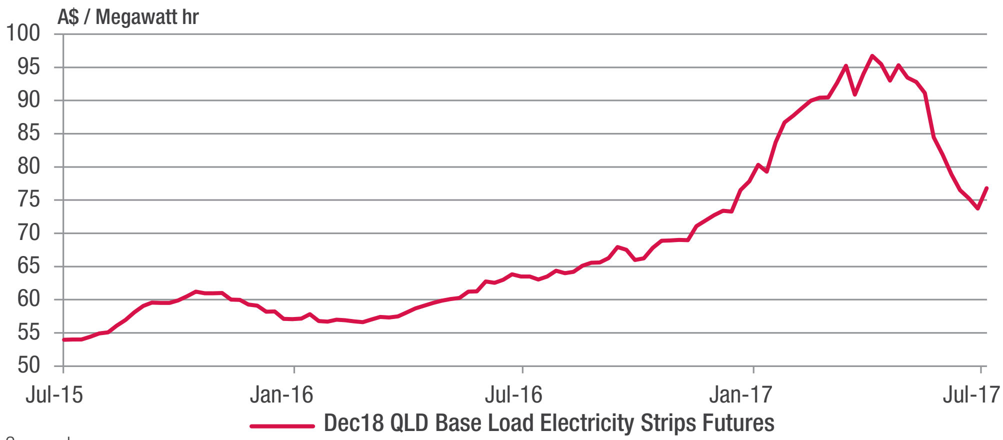
Listed entities with power generation activities benefiting from these price trends include AGL Energy, Origin Energy and Infigen Energy. Gas and electricity markets are closely linked, with gas prices rising strongly due to strong demand from LNG producers in Gladstone. Unfortunately, there is limited exposure to the rising gas price thematic available on the ASX, with our key pick being Senex Energy.

Higher energy prices most negatively affect companies that have energy-intensive operations. These include industrial manufacturers such as Orora, Brickworks, DuluxGroup, Orica, Incitec Pivot, and Pact Group. Cochlear and CSL in the Healthcare space will also feel the pinch given their strong manufacturing presence in Australia. Mining companies using grid-sourced power will be impacted, as will data centre operators. Australia's largest retailers, Woolworths and Wesfarmers, will not escape the higher cost of keeping the lights on and refrigerators running every day. Companies may look to mitigate the impact through cost saving strategies such as energy efficiency initiatives.

Governments have responded to the higher energy costs through various policy initiatives. The Finkel Review provided 50 recommendations to the Commonwealth aimed at delivering reliability, security, lower emissions and rewards for consumers. The South Australian Government's plan included utility scale battery storage and new generation. However, the Queensland Government's policy initiatives released on 5 June has had the most immediate impact. This included directing one of the two State-owned generation corporations to work to reduce wholesale power prices through its bidding behaviour. Both Queensland and NSW forward contract prices showed immediate decline. Pricing of renewable certificates has also begun to decline as supply of LGCs from new projects has increased.

These price movements suggest that the price rises for consumers may not be as dramatic and sustained as originally expected.

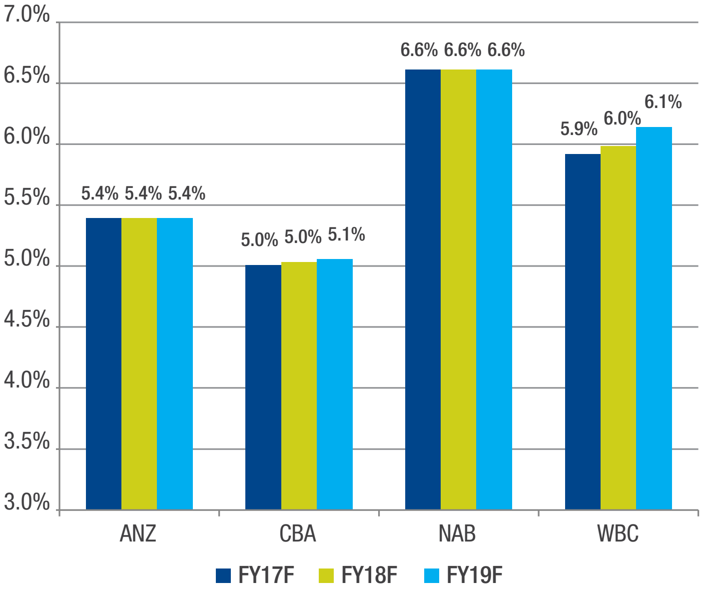
Energy prices have eased



Source: Iress

Banks update

Major bank forecast dividend yields



Source : Morgans forecasts

Banks – offering value

Major bank share prices experienced the 'Trump bump' between mid-November and late-April only for the Australian Government to then step in to spoil the party with the announcement of the major bank levy.

Weak sentiment stemming from the levy has also seen greater attention being paid to the bear points associated with an investment in the banks, particularly concerns about regulatory capital and the housing market. However, we believe much of the bearishness is overdone, meaning that the major banks offer good value at current prices, coupled with a solid dividend yield.

We believe the major banks can comfortably deal with the financial impact of the levy without needing to cut dividends. Our base case is that the majors will deal with the impact of the levy, which we expect to be 2-4% of annual earnings, through repricing loans and deposits. The majors have already been repricing parts of their home loan books to comply with macro-prudential rules and we believe this repricing will be largely sufficient to offset the impact of the levy.

On the regulatory capital front, APRA has now announced its expectations under the 'unquestionably strong' framework. This removes much of the uncertainty in relation to the capital outlook, and the outcome of APRA's announcement is better than the bears had anticipated. We expect the majors to meet APRA's new expectations without needing outright capital raisings and without needing to cut nominal dividends.

On housing, we do not expect to see a material decline in dwelling prices as long as the Government does not curb foreign ownership of Australian housing. From a credit quality perspective, we believe that important factors provide a buffer for the banks including: full recourse lending in the vast majority of cases; lenders' mortgage insurance coverage for high loan-to-value mortgages; and fairly conservative lending standards.

Resources update

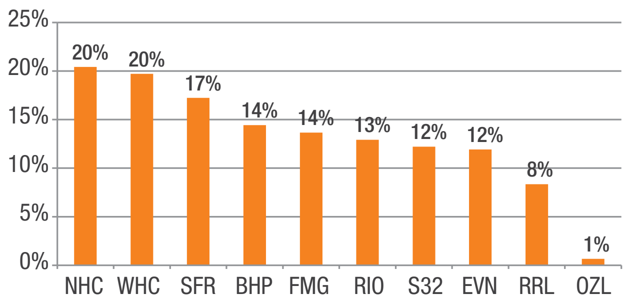
Resource Sector – looking strong

Miners have had a volatile ride so far in 2017 but the sector is in great shape despite the bumps. The major miners are enjoying their best cash flows since prior to the GFC and juniors have been able to recapitalise and get active.

Now is one of the best times we have seen to add to positions in both BHP Billiton and Rio Tinto. With little spending planned, we think that a steep increase in dividends and buybacks are almost inevitable for the 'Big 2' in the coming years. While they may not enjoy the same jump in dividends at their August results, we also see solid value in OZ Minerals and Oil Search. Both have established themselves as strong resource houses with strong earning power and growth potential that is not yet priced in by the market.

While the established mining franchises might be the best way to play the space at the moment, it isn't only the majors who will have fun over the next couple of years in resources. With no money to drill, most explorers spent recent years confined to their offices and were limited to only being able to work up a collection of drill-ready targets for their best projects. Now that money has started to flow back into the sector, allowing juniors to get back out into the field and start drilling, we expect a sharp pick up in exploration success to unfold across the junior end of the sector.

Large-cap mining free cash flow yields



Source: Morgans forecasts

The growth conundrum (high PE stocks)

The top 200 industrial companies are expected to grow profits by 8% in FY17 despite some negative earnings momentum heading into reporting season. The scarcity of growth outside of Resources pushing valuation ever higher in stocks that enjoy strong and dependable growth in earnings.

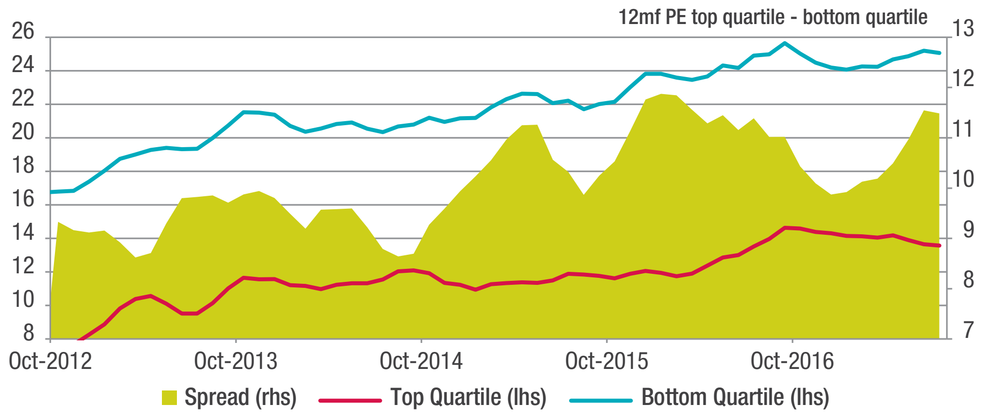
We caution however that the divergence between the most expensive (high PE) and the cheapest (low PE) stocks remains extended and that the market's recent treatment of disappointment from high PE stocks has been brutal.

This divergence presents opportunities in overlooked areas among select industrials where earnings momentum is recovering and where there is more valuation downside protection if the earnings recovery proves premature.

Investors need to handle high growth stocks with increasing care. Regardless of company fundamentals, we also caution that the high PE/ growth segment is vulnerable to blanket selling in volatile markets (i.e. a PE de-rating) simply by virtue of how strongly it has held up against some recent market weakness as investors have bought these companies for dependable and growing earnings.

High valuations make for high expectations. Companies that have missed expectations continue to underperform. While the average consensus downgrade of companies that have updated market is ~10% the share price reaction since the downgrade has been far more severe at ~16%. Stocks with high valuations with some earnings risk we see as the most vulnerable include Domino's Pizza and CSL. Again see our reporting season preview for more detail. Morgans preferred growth stocks focus on ability to achieve above average growth. Our current preferences include: **Corporate Travel**, **ResMed**, and **ALS Limited**.

High PE exposure looks priced for perfection



Source: Morgans, FactSet

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High Conviction Stocks

Watch our analysts outline key reasons to buy our recently added stocks in short videos available here
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All eyes on reporting season

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We have added Motorcycle Holdings to the list this month.

Motorcycle Holdings is Australia's largest motorcycle dealership operator, engaging in all aspects of the retail chain (new, used, parts, service, accessories and F&I). MTO is the first and only player looking to consolidate this highly fragmented industry, driven by aligned management with +30 years industry experience. The FY17 result should highlight how much MTO has outperformed the new motorcycle sales market, while FY17 acquisitions should also drive +17% earnings growth into FY18. MTO looks to be trading on a fair multiple at 13.6 times, but we think the market is always going to be chasing growth here as MTO's executes a multi-year acquisition and consolidation strategy.

For more detail refer to our latest High Conviction Stock list published 31 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	$9.38	$10.23	1.9%	1.9%	25.6	11%
Westpac	WBC	$31.53	$38.00	6.0%	8.6%	12.2	29%
Oil Search	OSH	$6.47	$10.16	2.0%	2.0%	21.2	59%

Ex-100

	Ticker	Price	Price Target	FY18 Dividend Yield	FY18 Gross Yield	PE 12mf (x)	12m TSR
Motorcycle Holdings	MTO	$4.25	$4.23	4.0%	5.8%	14.8	5%
Bapcor	BAP	$5.57	$6.22	3.1%	4.4%	17.5	16%
Australian Finance Group	AFG	$1.46	$1.65	7.0%	10.0%	10.0	23%

Source: FactSet Data as at 4 August 2017

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