October 2017

Investment Watch

Making the most of market conditions

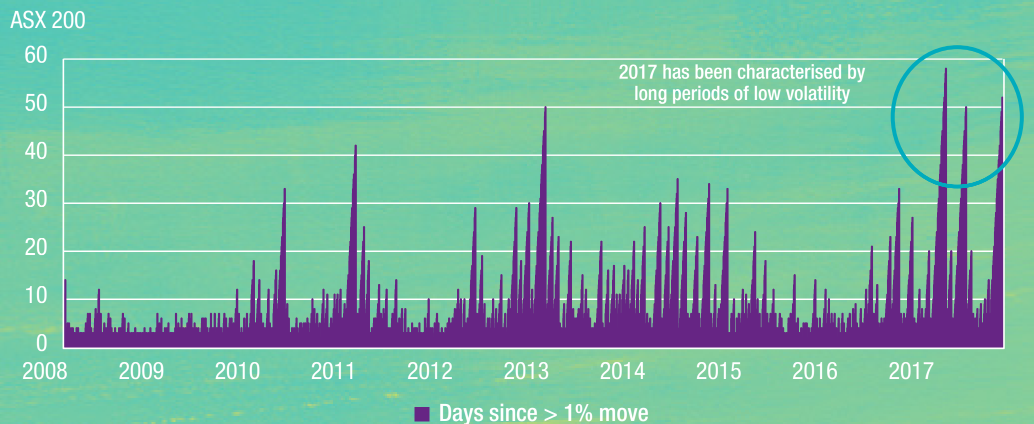
The market's sideways trading still accurately reflects an economy that has failed to break decisively out of its post-mining slump. It will take some acceleration in business activity before investors are likely to see growth revert back to the long-run average. Meanwhile the valuations investors are paying for earnings remain elevated and we caution against expectations of above-average returns.

However, low volatility and a range-bound market can mask opportunities and threats. Large caps broadly disappointed at recent results while the small caps fared better in absolute performance. We think this signals a change in leadership and should see investors again seek growth outside of the market stalwarts. Several names now offer much more compelling upside in a directionless market, supported by upcoming catalysts. We nominate nearly three dozen positive and negative catalysts to watch/avoid on page 3.

The subdued consumer remains an overhang for a broader economic recovery and while we remain broadly cautious on the retail sector, we do see opportunities amongst the 'noise'. We explore the outlook for the sector in more detail on page 4. This month we also look at the challenges facing the telco sector and who the likely winners and losers will be as competition intensifies.

Over the past four years, we have referred to the Federal Reserve discussion of the natural rate of unemployment. Full employment or the natural rate of unemployment is the level of unemployment which neither accelerates nor decelerates inflation. The unemployment rate is a crucial input to the RBA's decision making process each month so we look at how the Bank shapes monetary policy in the context of the natural rate of unemployment and what this means for interest rates on page 2.

S&P/ASX 200 volatility – A remarkably calm period for equity markets



Source: Factset

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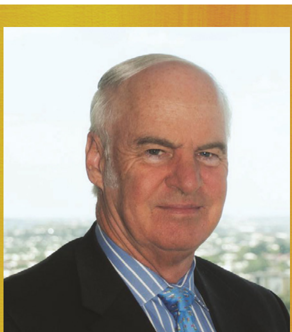


Listen to the latest podcast from Morgans Chief Economist, **Michael Knox** as he explains **the Natural Rate of Unemployment and the RBA.**

https://www.morgans.com.au/blog/

Economics – the natural rate of unemployment and the RBA

Over the past four years, we have referred to the Federal Reserve discussion of the natural rate of unemployment. The whole idea of the natural rate comes from the work of a 19th century Swedish economist called Knut Wicksell. Wicksell talked about the natural rate of interest as an equilibrium rate of interest which neither accelerates nor decelerates an economy at full employment. Full employment or the natural rate of unemployment is the level of unemployment which neither accelerates nor decelerates inflation.

In the US, the FED calls this level of unemployment 'the natural rate'. In Australia, the RBA calls this the NAIRU (no, not an island in the Pacific). The NAIRU in economics means the non-accelerating inflation rate of unemployment. In practice, this is the level of unemployment which stabilises inflation at the target inflation rate of the central bank. When the RBA talks about the NAIRU, it is talking about exactly the same thing as the Federal Reserve when it talks about the 'natural rate of unemployment'.

The RBA publishes a series of academic papers prepared by its staff in its quarterly publication 'The Reserve Bank Bulletin'. The June 2017 edition of the Reserve Bank Bulletin contains an article called 'Estimating the NAIRU and the Unemployment Gap'. This article is written by Tom Cusbert of the economic analysis department.

Cusbert notes that labour under-utilisation is an important consideration for monetary policy. Reducing it is an end in itself, given the RBA's legislated mandate to pursue full employment. He says that, the NAIRU or non-accelerating inflation rate of unemployment, is a benchmark for assessing the degree of spare capacity and inflationary pressures in the labour market. When the unemployment rate is below the NAIRU there will be upward pressure on wage growth and inflation. When the unemployment rate is above the NAIRU there will be downward pressure on wage growth and inflation.

The estimated NAIRU peaked in 1995 at an unemployment rate of 7%. It has declined since then to around 5% in 2017. Cusbert notes that the fall in the NAIRU over the past 20 years has occurred during a prolonged period of economic growth.

Cusbert says that, "the relationship between unemployment and prices is non-linear". This means that, unemployment has less of an effect on inflation and wages growth, the higher unemployment becomes. He says the current estimate of the NAIRU is 5%.

When updating the economic forecasts each quarter, the RBA staff use the latest estimate of the NAIRU as an input into the forecasts for inflation and wages growth.

Conclusion

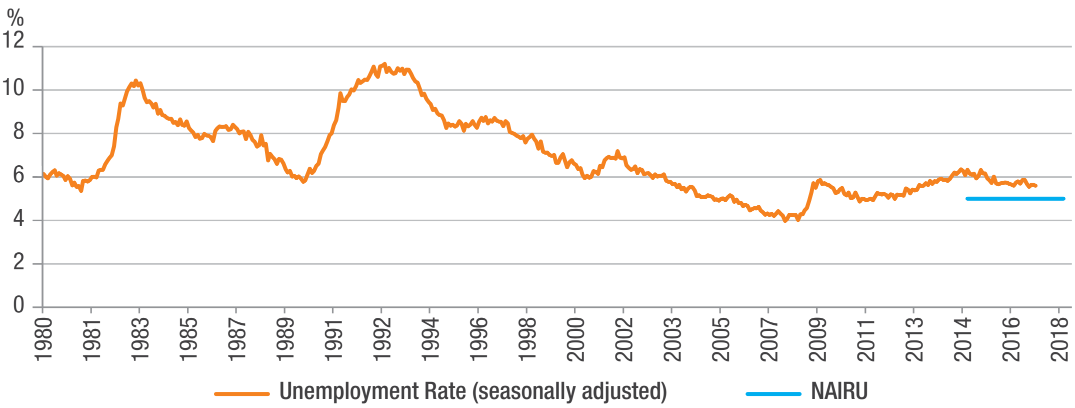
Cusbert tells us that estimates of the NAIRU are an input into the RBA's inflation and wage forecasts, which in-turn feeds into monetary policy decisions.

Our examination of the statistical data provided with this paper suggests that the effect of unemployment on unit labour costs is as much as five to eight times the effect of unemployment on inflation. This, if anything demonstrates the effect of import prices on inflation in an open economy like Australia.

We note that unemployment is now at 5.6%. This is still well above the natural rate or NAIRU of 5%. Unemployment still needs to fall a long way before it can generate enough wages growth or enough inflation for the RBA to need to increase the level of short term interest rates from the current level.

For more detail refer to the Reserve Bank Bulletin article Estimating the NAIRU and the Unemployment Gap https://www.rba.gov.au/publications/bulletin/2017/jun/2.html

Australian Unemployment rate and NAIRU



Source: RBA

Equity strategy – investment ideas for a directionless market

Making the most of market conditions

Volatility has been remarkably absent with the S&P/ASX 200 trading in a tight range between 5650-5850 over the past four months. The market's sidewise trading still accurately reflects an economy that has failed to break definitively out of its post mining boom slow patch. It will take some stronger evidence of a clear acceleration in business activity before equity investors are likely to see improved outcomes. The much touted Trump rally has taken a U-turn and the likelihood of any further monetary support is low. So without the necessary ingredients for another broad based rally, fundamentals and stock specific catalysts will provide the important source of alpha over the next few months. In this piece we highlight 36 stock catalysts which we think have the potential to move prices, both positive and negative, over the coming months.

Focus shifts to 1H trading conditions and the FY18 outlook

In our reporting season review we flagged that stocks (on aggregate) looked expensive when measured against delivered earnings and their overall cautious outlook for FY18. We also cautioned against investor complacency during abnormally low volatility as the calm can mask significant stock moves. A number of notable large caps disappointed (CSL, Telstra, James Hardie, Ramsay Health Care, Woolworths) while the small caps fared better in performance. We think this signals a change in leadership and should see investors again seek growth outside of the market stalwarts. The AGM season commencing this month therefore shapes as more important than usual in better defining the market outlook particularly if improving business sentiment continues to buoy confidence.

Volatility has been suppressed but not extinguished

The Bulls see low volatility as a by-product of conditions ideal for stocks to continue edging higher. They make the point that middling economic growth has kept the Fed from tightening monetary policy too quickly, and as a result, investors haven't fled from equities in a disorderly fashion. The rally has also been supported by an expansion in US corporate profits.

The Bears point to a lack of worry in the current 8-and-a-half year bull market as a signal that complacency has made traders vulnerable to unforeseen shocks. The fact that geopolitical risks are creeping up (populist political agendas, Central Banks tightening policy, North Korean tensions) compound that view.

We think that investors are being asked to tread a fine line. We update our asset allocation strategy and setting every quarter in Investment Strategy and currently advocate cautious positioning with a higher than usual cash allocation.

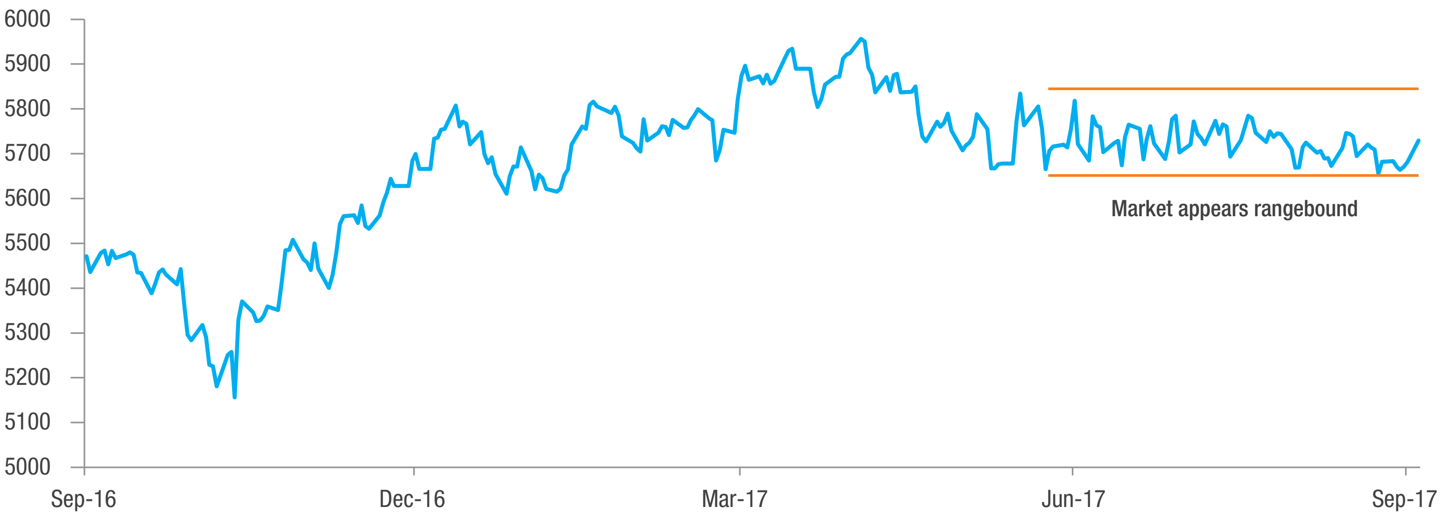
Market noise masks the opportunities and threats

Our recently updated **High Conviction list** and **FY17 Reporting Season Review** highlight our best ideas post a lacklustre reporting season. Several names now offer much more compelling upside potential in a directionless market, supported by upcoming catalysts. We nominate nearly three dozen positive and negative catalysts to watch/avoid below.

For more detail refer to our note Upcoming Catalysts published 25 September 2017.

Upcoming stock catalysts	
Potentially Positive	BHP, CBA, Suncorp, Orora, Wesfarmers, Kina Securities, Domino's Pizza, Lovisa, Bapcor, Motorcycle Holdings, Adairs, Seek, APN Outdoor, IPH, Blue Sky Alternatives, Volpara, Flight Centre, Elders, Nanosonics, Blackmores, Webjet, Impedimed
Potentially Negative	Incitec Pivot, Orica, Coca-Cola Amatil, Thorn Group, Amcor, QBE, Origin Energy, Santos
Uncertain/Noteworthy	Nufarm, Murray Goulburn, Australian Finance Group, Macquarie Atlas Road, Transurban

S&P/ASX 200 Index – lacking direction



Source: Factset

Healthcare – a steady but unspectacular prognosis

With the reporting season now behind us, most of the ASX200 Healthcare companies reported results broadly in line expectations, except hospital operator Healthscope. Overall commentary from the companies with operations in Australia suggests continuing pressure from governments to cut fees, patient volume growth showing a modest recovery (in part driven by a bad flu season) and a benign regulatory environment (as the Government review of medical benefits scheme continues). The companies generating revenue from offshore have being negatively impacted by a higher Australian dollar and the uncertainty created by healthcare reforms in the US. This has resulted in most of our larger healthcare companies guiding to modest profit growth of 5% to 10% for this year. However when you consider that we are in a low growth low inflation environment that is a good place to be investing.

Our key calls are **Ansell** which is expected to deliver double digit earnings growth and **Sonic Healthcare** with capacity to continue to consolidate its market leading position in countries like Germany. Against this backdrop we see emerging trends in areas like digital health where the convergence of digital and genomic technology

is empowering people to better track, manage and improve their own health. An exciting digital health play is **Volpara Health Solutions** where its technology is being used to measure breast density (amongst other measures) and improve the ability to better detect breast cancer.

Retailing – opportunities amongst the ‘noise’

We remain broadly cautious on the retail sector, but do see opportunities amongst the ‘noise’. The consumer appears to have recovered somewhat following very weak sentiment in early CY17, as evidenced by a reasonable reporting season from the listed retailers. However, consumer pressure remains via:

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

While the consumer ultimately adapts to the new ‘norm’, the above will likely continue to weigh on spending patterns short-medium term.

The state of the housing market is critical. A buoyant housing market has been one of the few tailwinds supporting the Australian economy and therefore spending in recent years. Some of the heat has undoubtedly come out of the market, however this had to happen and we expect reasonably solid conditions to persist from here, supported by historically low interest rates.

Supermarkets are increasingly trying to out-do each other to win over customers with more relevant product ranges, greater in-store service and better looking store layouts. However, one of the key levers pulled continues to be price. Given the ongoing sluggish Australian economy, price remains an important consideration for consumers looking to make their dollar stretch further. The need to keep prices competitive has eaten away at profit margins at Coles and Woolworths over the past couple of years and this is likely to continue given Aldi’s expansion into WA and SA and Costco opening up more stores. Kaufland/Lidl has flagged its intention to enter Australia in the medium term and while it is uncertain when Amazon will launch its Fresh offering, competition is only going to get more intense over time. Against this backdrop where pressure on earnings and margins remain, we don’t see any compelling reason to be exposed to the Retail Staples sector at this stage.

The aggressive discretionary retail sector de-rating we saw in late CY16 and early CY17 has stabilised if not retraced slightly, with valuations now more appropriately accounting for the earnings risk associated with Amazon’s eventual arrival in Australia. ‘Guesstimating’ continues by retail sector analysts as to Amazon’s potential market share impact on key categories such as electronics, sporting goods, homewares, clothing and toys. We believe low double-digit PEs are the new black for most discretionary retail stocks until Amazon’s impact is more easily quantified.

The impact Amazon is having on US retailers some 10 years on from its establishment is significant and we cannot underestimate the potential impact one of the best business models in the world can have on our local retailers. Retailers are now working hard to create world class online platforms, supply chain efficiencies and better supplier relationships in an attempt to make the consumer interaction as seamless as possible, which will be key to maintain share.

However, just like it has occurred overseas, we believe the strong/category killer retailers (**Beacon**, **Bapcor**, **Adairs**, **Lovisa** and **JB Hi-Fi**) who have invested for years ahead of this step-change in competition, will survive and potentially even prosper in a post Amazon world.

Telco – the pendulum is swinging back the other way

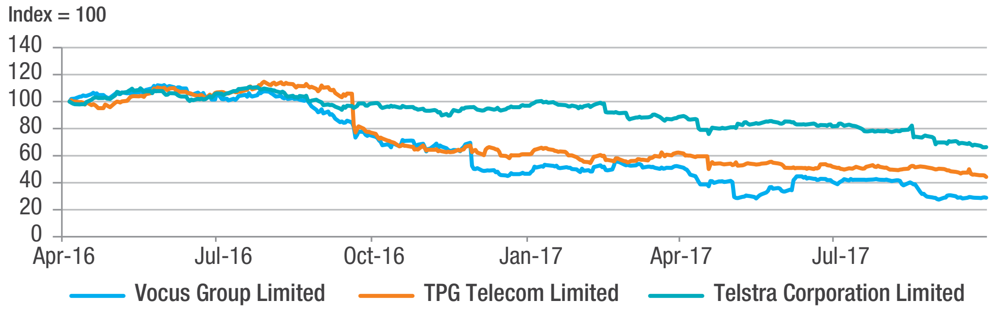
Australian Telecommunications remains a difficult sector for investors. Over the last 18 months we flagged a number of major headwinds for the sector including increased competition and margin pressure as the National Broadband Network (NBN) gains increased traction. This combined with, in our view, overpriced trading multiples saw us recommend investors take an underweight stance on the sector. Our sector view has not changed since then but the telco index (XTJ:ASX) has virtually halved in the last 12 months, which sees us starting to soften our underweight view.

At their full year results Telstra, TPG Telecom and Vocus (the top 3 ASX listed telecommunications companies) all materially cut dividends and/or future expectations. Telstra flagged a ~30% reduction in dividends going forward, TPG Telecom cut their final dividend from 7.5c in FY16 to 2.5c in FY17 and Vocus Group has frozen all dividends. There are plenty of negatives to grab headlines including substantial dividend cuts and the fact that within 6 months 1 in 2 Australian household internet connections will be running on the NBN. Nobody likes a dividend cut or a slow internet connection but this is the reality we are left with, for now.

However, we think it's also worth at least considering the silver lining. Firstly we think share prices, (especially Telstra's which we have just upgraded to an Add) are now more realistically pricing in these challenges. Secondly we continue to hold the view that the NBN will ultimately disappoint due to lower customer take-up and this could change the profitability dynamics back in favour of telcos. For now we see the best value in telecommunications as being outside of the consumer facing telcos.

Today the average Australian mobile phone connection is around 30% faster than the average Australian fixed line network speed (which is ~11Mbps according to Akamai). The problem is not speed the problem is cost. Currently it costs 15-20x more to move a Gb of data over a mobile network than a fixed network. However over time this cost differential will equalise, in our view. Increasing fixed line costs (thanks to the NBN) and declining mobile costs (due to competition and improving technologies like 5G and alternative wireless last mile connections) are the two key drivers to be aware of. That said it will likely be another 5 years for this thematic to fully unwind so for now we remain underweight telecommunications.

Telco sector price performance – a difficult 18 months



Source: Factset

Food and agriculture – pockets of value exist

Performance across the agri-food sector over the last quarter has been mixed and driven by varying stock-specific factors. We continue to hold the belief that an exposure to Australia's promising agri-food companies deserves consideration. The sector's medium to long-term fundamentals remain positive. Consumer demand for 'good-for-you' food products is growing strongly, 'brand Australia' still has huge appeal in Asian markets and our primary producers continue to lead the world in best-practice, sustainable and efficient farming methods. With this in mind, we believe pockets of value exist for patient investors (Namoi Cotton, Murray River Organics, Midway, Capilano).

Reporting season revealed the damage that adverse seasonal conditions can inflict on the balance sheets of those affected. The benefit in taking a conservative approach to growth capex was a key takeaway, as those who sustained the greatest increases in gearing levels (Murray River Organics and Select Harvest) were also impacted by slippage in expansive growth initiatives. While the market tends to find it difficult to look past these short-term headwinds, provided debt levels can be remedied appropriately, the return to normalised seasonal conditions should deliver improved shareholder returns.

M&A has also been a common thematic throughout the sector and its strategic use has varied between companies. The inherent value in Murray Goulburn's assets and supplier relationships have caused it to receive considerable interest from domestic (Bega Cheese) and global competitors. Others have looked to small, bolt-on acquisitions to support growth targets (Elders, Ruralco, Murray River Organics, Midway), while consolidation in the global ag chem sector has opened the door for more sizeable acquisitions for our domestic players such as Nufarm.

The upcoming 'Ag reporting season' (GrainCorp, Elders, Ruralco, Incitec Pivot) in November will provide investors with an update on the general health of the sector as a whole. The rural services companies in Elders and Ruralco have come under particular selling pressure due to expectations of a lower winter crop following dry seasonal conditions and the sharp fall in the cattle price from record highs as the herd begins to rebuild. GrainCorp has also been impacted by the dry season. Companies with strong management, a disciplined approach to capital allocation and a diversified business model such as **Elders** are best positioned to navigate the cycle.

Infrastructure – plenty of news flow

After a strong first half to the year over the last quarter all stocks in the infrastructure sector underperformed the broader market. Rising government bond rates (up about 30-40 bps) were the key macroeconomic headwind. APA Group (regulatory concerns, lower growth expectations), Auckland International Airport (major investment slated), Qube (capital raising, weakness in Patrick Container Terminals), and Aurizon (growth outlook) also had stock specific issues, some of which were unearthed during the August reporting season. Sydney Airport was arguably the strongest result during reporting season, including a 1 cps upgrade to its distribution guidance.

Macquarie Atlas Roads (MQA) is undertaking an entitlement offer to fund the purchase of a further stake in the APRR toll road in France. We recommend shareholders take up this offer. There is the possibility that MQA will buy a further stake in the APRR when another Macquarie fund looks to exit its APRR investment, which looks likely to require another capital raising.

Transurban (TCL) expects to reach commercial close on its $3.5-4.0bn West Gate Tunnel Project in Melbourne in late-2017. We anticipate TCL will undertake an entitlement offer to part-fund its investment in this project. A further capital raising may be required in mid-2018 if TCL is successful with a bid for NSW Government's 51% sell-down of WestConnex.

At this stage, our stock preferences are **Spark Infrastructure** (energy), **Macquarie Atlas Roads** (transport) and **Cleanaway** (waste management). We are looking for more beneficial buying points for big cap favourites Sydney Airport, Transurban, and APA.

High Conviction Stocks

Watch our analysts outline key reasons to buy our recently added stocks in short videos available here https://www.youtube.com/c/morgans-financial-limited

We remove Australian Finance Group (AFG) from our High Conviction list this month. It has been in the list a touch over three months but has reached and now trading around our price target of $1.70 - a TSR of ~38% since its inclusion. The growth outlook (8% 3-year EPS CAGR) remains solid backed by an attractive fully franked dividend yield (6.3% FY18) but we view the stock as fair value given the performance over the past few months.

The hunt for yield in an ultra-low interest rate environment has elevated asset values and is causing equity risk to be mispriced. Telstra's recent issues are a reminder of the vulnerability to bond-like equities when company specific drivers reassert themselves as they always do. We don't pretend to be able to call the macro with precision, and prefer to pick stocks which can thrive preferably irrespective of the macro-economic environment. Our High Conviction list represents our best ideas on a 12-month risk adjusted basis.

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

Morgans' High Conviction Stocks

ASX 100

	Ticker	Price	Price Target	FY18 Dividend Yield	FY18 Gross Yield	PE 12mf (x)	12m TSR
ResMed	RMD	$9.72	$10.52	1.8%	1.8%	26.0	10%
Westpac	WBC	$31.88	$38.00	5.9%	8.4%	12.4	28%
Oil Search	OSH	$6.98	$10.16	1.8%	1.8%	23.3	47%

Ex-100

	Ticker	Price	Price Target	FY18 Dividend Yield	FY18 Gross Yield	PE 12mf (x)	12m TSR
Motorcycle Holdings*	MTO	$4.23	–	–	–	–	–
Aventus	AVN	$2.28	$2.46	7.2%	7.2%	12.5	15%
NextDC	NXT	$4.49	$5.38	–	–	n.m	20%
Bapcor	BAP	$5.26	$6.19	3.2%	4.6%	16.7	22%
PWR	PWH	$2.39	$3.10	2.7%	3.9%	22.0	34%

Source: FactSet, IRESS. Data as at 4 October 2017.

* Morgans is the Lead Manager and Underwriter to MTO's capital raising and is therefore in research blackout.

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