morgans

Holiday Edition 2017

Investment Watch

A time for change

The Australian Equities market in 2017 can be best described as three distinct periods: 1) the Trump trade; 2) the Range trade; and 3) the Goldilocks trade. The Trump trade carried into the year the reflation theme of 2016 – this saw the ASX 200 Bank Index rise 5.6% in Q1 as expectations of higher inflation and growth fuelled a cyclical recovery. The optimism soon faded, with President Trump's policy reforms hitting roadblocks in Congress, falling bond yields and uncertainty led the market sideways trapped within a narrow range between 5630 and 5850 index points. In the back half of the year global economic uncertainty eased and volatility all but disappeared, the growth without inflation environment or 'Goldilocks trade' buoyed the markets towards the end of the year.

As we look ahead to 2018, markets remain in a sweet spot with global growth becoming entrenched and inflation still conspicuously absent. Interest rates are expected to rise gradually leaving businesses with a decent backdrop to work with and healthy growth puts the world in a better position to deal with the next downturn. A key question for 2018 is whether investors continue to shrug off geopolitical risks including escalating tensions in North Korea, increased trade protectionism and the future of the EU. Furthermore, higher interest rates usually signal a close to a bull market, so investors should be prepared for a return to more normal levels of market volatility.

Solid returns are still achievable in this market, however these should not come at the expense of investors taking on excessive levels of risk. We detail our investment strategy on page 3 and provide a comprehensive outlook for investment across all sectors from page 4.

2017 has been another exciting year of growth for Morgans. From all the staff and management we appreciate your ongoing support as a valued client of our business. We wish you and your family a safe and happy festive season, and we look forward to sharing with you what we believe will be a prosperous 2018.

Our key sector picks for 2018

Theme	Best exposures
Banks	Westpac
Diversified Financials	Link Administration, BT Investment Management, CML Group
Food and Ag	Nufarm, Inghams, Midway
Gaming	Aristocrat Leisure, Jumbo Interactive
Healthcare	Resmed, Sonic Healthcare, Nanosonics
Industrials	Orora, Emeco, PWR
Infrastructure and Utilities	Spark Infrastructure, Macquarie Atlas Roads, Cleanaway
Online Media and Technology	Carsales, Catapult
REIT	Aventus, Viva Energy
Resources	Oilsearch, Senex, Fortescue
Retail	Bapcor, Baby Bunting, Motorcycle Holdings
Telecommunications	Telstra
Travel and Tourism	Apollo Tourism, Webjet, Corporate Travel Management

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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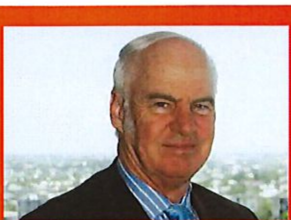

Listen to the latest podcast from Morgans Chief Economist Michael Knox on Equities, Iron Ore and Oil.

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

Economic update – looking forward with optimism

The world economy in 2018 will put in its best growth performance since the global financial crisis. Most major economies will grow more rapidly. The US economy should accelerate from 2.2% GDP growth in 2017 to 2.5% growth in 2018. The Euro Area, which looks like achieving 2% growth this year, should accelerate to 2.5% next year.

The Australian economy has had a fairly slow recovery in 2017. GDP growth for the full period of 2017 should only be around 2.1%. This should accelerate sharply to 3% in 2018.

In spite of fast growth, inflation appears to remain under tight control. CPI inflation in the US should fall from 2.1% in 2017 to 1.9% in 2018. In the Euro Area, inflation of 1.5% in 2017 will be followed by only a 1.2% increase in the Harmonised European CPI in 2018. Inflation in Australia will be stable with a 2% increase in the CPI in 2017 followed by a CPI increase of only 2.3% in 2018.

Major developing economies look just as good. China, which is growing at a 6.8% growth rate in 2017, should follow that up with at least 6.6% growth in 2018. India should accelerate from 6.7% growth in 2017 to 7.4% in 2018. This year for the first time we have begun to look at the major economy immediately to our north. Indonesia should accelerate from 5.1% growth in 2017 to 5.3% growth in 2018.

The Euro Area

Perhaps most remarkable is the rapid rebound in the Euro Area. The best model that we can construct of activity in the Euro Area is based on the business sentiment indicator published every month by the European Commission. As business sentiment rises, investment rises. As investment rises, output rises. As output rises, employment rises. Our model based on European business sentiment appears to explain more than 80% of variation in Euro Area GDP. This model now shows the Euro Area economy is growing as fast as it was in 2011, in the recovery from the financial crisis and almost as fast as it was in 2006, in the period of great prosperity before the financial crisis.

Europe is now taking up its great stock of unemployed workers. Unemployment has fallen from a peak of 12% in 2014 to a level of only 9% now. This is still a very high level of unemployment when we compare it to the level of just over 4% in the US. Europe will continue to grow long after the US has already put all of its unemployed back to work. We are looking at a period of years when the Euro Area economy will be growing significantly faster than the US. We think this could result in a surprisingly strong Euro. The US$ will be significantly weaker than what we expect against other major currencies. This benign outlook for the US$ provides the opportunity for a recovery in US$ commodity prices.

Equities market

The strength of the US economy is generating continued upward pressure on US corporate profits. There continues to be a steady appetite for equities. Relatively low interest rates, together with strong earnings, provide continued upward pressure for equities.

In Australia, earnings are beginning to recover from a long flat period. That recovery in earnings, together with a very liquid international capital market, should support a stronger outlook for Australian equities. We estimate fair value for the ASX200 is now 6200 points. We believe the ASX200 will reach that level no later than April 2018.

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Australian Economic Forecasts End of 2018

	Morgans Forecasts	Market Consensus
GDP Growth	3.0%	2.8%
Inflation	2.3%	2.2%
RBA Cash Rate	1.50%	1.75%
AUD/USD	77.5c	80c
ASX 200	6200*	6100

* by April 2018

Equity strategy – stay vigilant heading into 2018

The festive season is usually kind to equities. For the past 25 years, December has recorded the best monthly returns for both Australian and US equities at around a 2% average gain. Furthermore, both markets have recorded gains in December more than 75% of the time over this period. The theory goes that lighter market volumes (due to market participants taking holidays) restricts the supply of equities for sale, making it easier for buyers to push up prices.

The market remains locked in a 'Goldilocks' scenario, where global synchronised growth and low volatility continues to buoy investor confidence while low inflation sees central banks in no hurry to accelerate interest rate normalisation. Healthy growth puts the world in a better position to deal with the next downturn, but we are not ignorant of the risks and we remind investors to remain vigilant as these ideal conditions for equity markets are unlikely to continue through 2018.

Weighing up the geopolitical risks

A number of geopolitical risks could affect trade and market instability in 2018, including UK talks to leave the EU, political gridlock and instability in Washington, tensions over North Korea's missile and nuclear program and increased trade protectionism. While we don't see a need for investors to be alarmed at this stage, investors should be prepared for at least some potential for an escalation of these risks. Leaving some cash on the sidelines is prudent at a time where significant risks stand on the doorstep.

A turning point for interest rates

In 2013 the mere hint that the US central bank (The Federal Reserve) would end its unprecedented emergency measures caused investors to throw a 'taper tantrum' devastating Emerging Markets. Markets are currently pricing in a slower pace of interest rate rises and taking each increase in its stride. But this could all change if inflation surprises off very low expectations, unemployment rates around the globe have fallen where the US is now sitting at 4.1% where many officials deem to be in full employment while capacity utilisation is back at pre-GFC levels. Higher interest rates usually signal a close to a bull market, so investors should be prepared for a return to more normal levels of market volatility.

Australian market – needing an earnings catalyst

The equity market's underperformance against its global peers still accurately reflects an economy that has failed to break decisively out of its post-mining slump. Low growth and low rate settings have made investing for yield a profitable strategy for much of the post-GFC period. We are starting to see limits to this well-worn strategy. ASX 200 Industrials ex-Financials earnings per share (EPS) growth is forecast (by Thomson Reuters I/B/E/S) between 4% to 7% over the next three years, falling well short of the 11% average over the past 15 years. The market may continue to lag global peers until investors get a clearer read on a genuine acceleration in the business cycle. We think active stock selection will be key to returns in 2018.

Performance of strategy products

The Morgans research team and the Morgans investment committee produce two flagship products that contain our best equity ideas.

- The **High Conviction Lists** (updated monthly) detail those stocks we think offer the highest risk-adjusted returns over a 12-month timeframe, supported by a high level of confidence. We're pleased to report that in the last 12 months the average 'High Conviction Pick' has generated a 13% total return in less than eight months. Strong Buy ideas in the current lists include Oilsearch, ResMed, Westpac and Link Administration. See page 11 for more detail.
- The **Equity Model Portfolios** (also updated monthly) combine individual stock selection (often High Conviction ideas) to build the most appropriately constructed portfolios matched to income, balanced and growth investing styles. Via these portfolios we are also pleased to demonstrate meaningful 12-month total returns ranging from 13.8-16.4% in what has been a challenging 12 months for investors. See our website or contact your adviser for more detail.

What does it mean for 2018?

Australian shares are now trading ~3% below our estimates of fair value. While the yield differential between bonds and equities still favours equities, we are cognisant of the potential for the risks above to trigger ongoing volatility. We think that such unprecedented times require investors to take a more flexible approach in 2018 and that several tactical considerations are worth noting in this environment.

Moderate expectations of equity returns
Given the reality of below-average growth, investors need to caution against expectations of above-higher returns.

Beware of complacent investing
Resist assuming higher risk in pursuit of diminishing returns. This includes large cap stalwarts.

Follow conviction themes and stocks
Strong returns are achievable in Australian stocks, albeit in less traditional stocks and sectors.

Diversify internationally
Capture relatively compelling growth dynamics and currency tailwinds offshore.

Be opportunistic
Retain cash to protect capital and capture opportunities.

Strong returns are still achievable in this market, as we detail in our discussion around our key Research products. However, these should not come at the expense of investors taking on excessive levels of risk.

Banks – strong capital to underscore dividends

2017 started off with much uncertainty about the extent to which regulatory capital requirements for Australian banks will be increased. Bank bears were predicting large capital raisings in the year ahead as well as hefty dividend cuts. APRA announced the extent of increase as part of its 'unquestionably strong' framework and it turned out that the increase was in line with our expectations, meaning no need for outright capital raisings or dividend cuts. We head into 2018 with clarity on capital and with bank dividends looking robust.

System housing credit growth has held up well since the announcement of restrictions on interest-only lending in March of this year. With all four major banks having met APRA's cap on interest-only flows in the Sep-17 quarter, the majors are now in a position to grow interest-only home loan flows in line with total home loan flows. That is, we expect the interest-only cap to be less of a drag on system home loan growth going forward.

While the major bank levy is negative for net interest margins, margins are being supported by loan repricings, reduced term deposit competition and a lower marginal cost of term wholesale funding.

The environment remains benign for asset quality, and while the year started off with concerns about resource and New Zealand dairy exposures, these concerns waned over the course of the year. Looking ahead, exposures to the retail trade sector are cause for concern; however, the banks generally appear to be actively monitoring such exposures.

Westpac (WBC) remains our preferred major bank as we believe it offers the most compelling valuation at current share prices and we also view WBC as having a relatively low risk profile. ANZ remains our least preferred major bank as the results to date of the remedial action it has been taking in its institutional banking division have been underwhelming and we view ANZ as having a relatively high risk profile.

Online media and services – shock and awe

The online media and services sector roared to record highs this quarter, with the Morgans index of leading online stocks up 42% in the year to date. While the US has been shocked by the performance of the FANG stocks (Facebook, Apple, Netflix and Google), Australian investors have been awed by the records set by the big three local online names – Carsales.com (CAR), SEEK (SEK) and REA Group (REA).

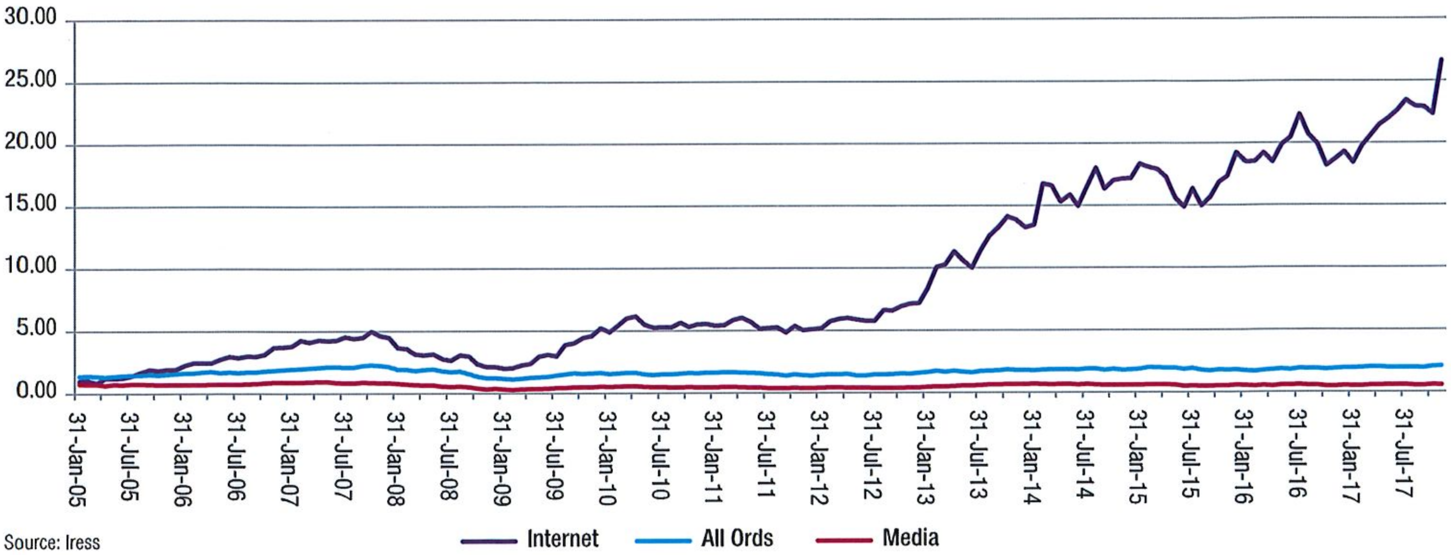
At the time of publication CAR, SEK and REA are up 33%, 24% and 36% respectively year-to-date. Some of the smaller online names have also had a terrific year, with Frontier Digital Investments (FDV) up 36% and LiveHire (LVH) up 219%. Laggards have included iCar Asia and Catapult Group (CAT), down 23% and 42%, respectively.

While we remain optimistic about the future of online businesses, there is an argument in favour of investors trimming big overweight positions in highly-valued stocks such as REA and SEK, both of which are now trading at all-time highs. While we remain positive on both companies in the long run, the share prices seem to be running in advance of fundamentals and a 10-15% pull-back for both stocks would not surprise.

Unlike the other two local names, we are not in favour of trimming positions in **CAR**. The company recently acquired 100% of its Korean online advertising business, which has the potential to turbo-charge earnings growth.

Looking to 2018, smaller names such as **Redbubble (RBL), CAT FDV** and **LVH** have the potential to perform strongly if they successfully implement current strategies and don't encounter unexpected headwinds. However smaller names are, by their nature, higher risk and not for all investors.

Morgans Internet Stocks vs All Ords and Media Indices



Source: Iress

Infrastructure – strong cash flow on offer

Over the last 12 months, total returns from most core energy and transport infrastructure stocks outperformed the broader market. The exceptions were Auckland International Airport (AIA – major capex program) and Aurizon (AZJ) (constrained growth outlook). While each stock had its own specific influences, the broad thematics driving sector returns were falling interest rates and the market's appetite for companies with defensive and growing earnings and strong balance sheets.

In the electricity generation/ retailing space, AGL benefited from higher electricity prices (surplus baseload generation) and ERM Energy (EPW) guided for improved domestic margins, while Infigen Energy (IFN) retreated due to lower forward prices for large-scale generation certificates and power sales. Also of note has been the strong performance of Cleanaway (CWY), with a respected CEO driving a turnaround at the waste management company.

At the time of this report, both Transurban (West Gate Tunnel Project) and CWY (acquisition of Tox Free Solutions) were undertaking capital raisings to fund major capital investment. We anticipate further capital raisings by Macquarie Atlas Roads (internalisation) and Transurban (possible 51% WestConnex acquisition from NSW Government) in 2018. Other potential capital raisings include Aurizon (potential WICET acquisition) and Auckland International Airport (major capital program).

Based on our valuations, which assume interest rates normalise upwards, a number of core infrastructure stocks look fair to fully priced at present. We suggest trimming overweight positions in AST, APA Group, and Sydney Airport. For active investors, infrastructure stocks are likely to provide short-term trading opportunities, moving in the opposite direction to government bond rates. For income-oriented investors, the sector will continue to be attractive for its attractive yield and growing distributions.

Our sector preferences are **Spark Infrastructure** (SKI) in energy infrastructure (highest yield, guidance for DPS growth), **Macquarie Atlas Roads** (MQA: tax rate cuts, falling AUDEUR, low European interest rates, traffic growth, internalisation underway) in transport infrastructure and **Cleanaway** in waste management.

Stock	Price	Forecast Return			
		Target Price	Upside %	Yield %	1yr TSR
Energy infrastructure					
APA Group	$8.91	$8.35	-6%	5.0%	-1%
AusNet Services	$1.92	$1.77	-8%	5.1%	-3%
Spark Infrastructure	$2.70	$2.69	-1%	6.0%	5%
Transport infrastructure					
Auckland International Airport	$6.13	$6.08	2%	3.7%	6%
Aurizon	$5.33	$5.13	-4%	5.2%	1%
Macquarie Atlas Roads	$6.20	$6.24	2%	3.5%	6%
Sydney Airport	$7.31	$7.11	-3%	4.8%	2%
Transurban	$12.28	$11.94	-3%	4.4%	1%
Electricity generation and retailing					
AGL Energy	$25.76	$26.88	4%	4.8%	9%
ERM Power	$1.39	$1.39	0%	5.3%	5%
Infigen Energy	$0.69	$0.59	-11%	0.0%	-11%
Other					
Cleanaway Waste Management	$1.47	$1.60	9%	1.8%	11%
Qube Holdings	$2.62	$2.62	0%	2.1%	2%

* Blue font denotes Factset consensus forecast. Data as at 12 December 2017.

Fixed income update

On the back of the new Bendigo and Adelaide Bank (BEN) and Suncorp Group (SUN) Additional Tier 1 (AT1) instrument issues, Bank of Queensland (BOQ) launched a replacement offer for the callable BOQPD. The new security is callable by BOQ in June 2024 and will pay investors gross distributions based on a rate of 3.75% above the 90-day BBSW. We would expect the security to be well supported due to the lack of primary issuance seen in the space over the past six months as all of the recent deals have been roll deals for existing securities. We continue to expect this theme into 2018 and suggest investors wanting to position for potential new AT1 security issues buy **CBAPC, MQGPA** and **WBCPC.**

Disclaimer: Morgans is a Joint Lead Manager to the Issue of BOQ Capital Notes and may receive fees in this regard.

Diversified financials – conditions in place for a solid 2018

As we head towards Christmas, 1H18 appears to be shaping up as a positive period for IAG and Suncorp. So far this half, the weather is supportive of strong December results for both companies, although we acknowledge there remains one month until period end. Elsewhere in the Insurance/Diversified Financials sector, press reports have both AMP and Suncorp looking to divest their life insurance businesses. We see AMP's life business as the more attractive of the two assets, and think a sale may provide a catalyst for the stock given it would lower its risk profile and improve returns. We maintain our ADD recommendation on AMP, as we believe the worst is over for the stock and it remains good value trading on only ~14x PE. Overall our No 1 sector pick continues to be **Link Administration** (LNK). In our view, LNK will deliver strong double digit EPS growth over each of the next 3 years. We also expect growth trends in LNK's core Fund Administration business to improve into FY19. Of all the other stocks in the sector, we maintain a watching briefing on MQG. While MQG is tipping the A$100 mark, it remains reasonable value on ~14x FY18F PE and it's hard not to see the stock benefiting from further infrastructure tailwinds in the near term.

The backdrop for global fund managers through 2017 has been very supportive, with global markets (MSCI World Index and the Dow Jones) up close to 20%. The lift in funds under management (FUM) for global managers (namely BT Investment Management and Magellan Financial) supports a solid earnings outlook; however, the market is exercising some caution towards the potential for a market pull-back, which has seen share price performances broadly in-line with the domestic market (we advise using any market volatility to be nimble with stock positions in BT Investment Management (BTT) and Magellan Financial Group (MFG)). Our economist believes that economic growth will be strongest in the Euro region over the next 18 months, which supports adding **BT Investment Management** to portfolios at current levels.

At the very small-cap end of the Diversified Financials sector, we see strong potential for CML Group (CGR) over the next year. As major banks have pulled away from niche lending segments, this has opened up the opportunity for CGR to grow its invoice financing business.

Refer to our Initiation on CML Group published 10 October for more information.

Food and Ag – solid long-term fundamentals

The long-term fundamentals of the agri-food sector remain strong and are supported by the world-leading practices of our primary producers and continued demand for healthy, 'good-for-you' food products. Over the last quarter, the market has once again become intrigued by the strength in Chinese demand. Following the Chinese government's suggestion of a more supportive regulatory environment for those selling through the cross border e-commerce channel and an apparent stabilisation in the infant formula market, there has been a significant broad-based rally in largely all stocks leveraged to the world's second largest economy (Bellamy's Organic, Blackmores, A2 Milk and Bubs Australia). While we recognise the market opportunity is large, we believe these companies have run ahead of their near-term fundamentals, trading at an approximate 50% premium to their larger, global FMCG peers. In light of potential regulatory risk, we believe current valuations do not provide investors with a requisite level of safety to justify an investment. We are also cognisant that profit-taking could occur in the short term given their rapid share price appreciation.

With our FMCG universe looking fully valued, we believe **Nufarm** (NUF) is attractively priced and a great way to gain exposure to the global agriculture market. The company has recently strengthened its growth profile and earnings quality through the acquisition of two high-margin product portfolios situated in Europe. Given these acquisitions should improve group margins over time, we believe NUF's valuation discount to domestic and global peers should gradually narrow. NUF is well diversified across geographies, which better positions the company to withstand the impact of unfavourable seasonal conditions. While not overly material to group earnings, recent rainfall in Australia's key cropping regions and the BOM's forecast of above median rainfall over December to February, have supported the outlook of the summer crop and at the very least, should improve market sentiment toward the stock. A large summer crop also has positive implications for the sale of agricultural inputs.

Other key picks in the sector include **Midway** (MWY) and **Inghams** (ING). Both are fundamentally cheap and offer attractive fully-franked distribution yields.

Gaming – M&A on the cards

The big news in the gaming space is the Australian Competition Tribunal's approval of the merger between Tatts Group (TTS) and Tabcorp (TAH). TTS shareholders have approved the merger and we anticipate the merger to complete in 2H18. In other merger news, Crown Resorts (CWN) has confirmed it is in discussions with interested parties regarding its CrownBet investment. The mooted potential purchasers of the 62% interest in CrownBet are William Hill and Betfair, which both currently operate wagering brands in Australia and are looking to bulk up their operations. Our preferred exposures in the gaming space are **Aristocrat Leisure** (ALL), The company is a leading gaming content developer and we believe it is well placed to extract further gaming machine market share growth in the near term due to strong content and product releases. The other pick of the sector is **Jumbo Interactive** (JIN), which we expect to report a strong 1H18 result due to a solid jackpot run.

Retail – opportunities amidst the noise

It's been a tough 2017 for the retail sector with valuations under pressure ahead of Amazon's entry and persistently shaky consumer confidence. Looking into 2018, we remain as cautious as we were at the start of 2017, but continue to see select trading opportunities amidst the 'noise'. We believe that low double-digit PE multiples are now the new black for most discretionary retail stocks until Amazon's impact is more easily quantified. On top of relatively capped PE ratings, we also believe that any top-line/margin wins from domestic retailers (above what the market is expecting) will likely be reinvested to provide additional protection in the medium-long term – thereby making earnings surprises less likely for the larger distributors of third-party brands. The impact Amazon is having on US retailers 10 years on is significant, so we can't underestimate the potential impact locally. However, just as has happened overseas, we believe the stronger/category killer retailers who have invested for years ahead of this step-change in competition, will survive and potentially even prosper in a post Amazon world.

At a consumer level, confidence remains tepid with the effects of higher utility costs, out-of-cycle mortgage rate hikes and lower wage growth all playing their part.

We prefer those retail categories/stocks that are more insulated from a significant Amazon impact (**Apollo Tourism**, **Bapcor**), still have a reasonable (and realistic) store rollout runway (**Baby Bunting**) and command strong competitive positions (**Apollo Tourism**, **Bapcor** and **Baby Bunting**). We also remain positive on the business models of Lovisa and Beacon Lighting but acknowledge the valuations on these stocks are now fair.

Retail staples – tough times likely to get tougher

The retail staples sector remains difficult with the major supermarkets battling a number of headwinds. Consumer spending is under pressure and with the supermarket trolley making up a meaningful chunk of a household's weekly budget, it is no surprise that consumers are continually on the lookout for the best offers. In an effort to entice customers into their stores, Woolworths and Coles are constantly trying to out-do each other with more relevant product ranges, greater in-store service and better looking store layouts. Price however remains an important factor, and with prices likely to keep trending down, pressure on supermarket margins continues.

Adding to the downward pressure on pricing is the further expansion of discount operators such as Aldi and Costco. Both have had enormous success since launching in Australia and their offerings continue to resonate with Australian consumers. As they grow they take further market share away from the incumbents and the more consumer spending is under pressure the more it plays into these players' hands. Following the success of Aldi and Costco, Kaufland has also entered Australia and will commence operations in the next few years. Despite the industry already being highly competitive, Kaufland's due diligence has obviously uncovered an opportunity and they see Australia as part of a wider global expansion drive. Then there's Amazon, which will no doubt launch its Fresh service in due course.

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 in the near term.

Travel and tourism – flying high

We retain a positive view on the travel and tourism sector given its attractive growth profile – it is a GDP plus industry which generates strong cashflow. Our key picks in the sector are **Apollo Tourism** (ATL) and **Webjet** (WEB) given we believe that both of these stocks are attractively priced for their growth profile. ATL looks well placed to exceed consensus forecasts, driven by solid organic growth and recent acquisition activity. We expect further accretive deal-flow in coming years, including a potential entry into the large European market. Given its recent investment, WEB has at least three strong earnings growth years ahead. We believe the stock has been oversold after recently providing FY18 guidance which was below consensus expectations. With Mantra Group (MTR) receiving a takeover offer from AccorHotels, shareholders wanting to keep their exposure to the sector should either take profits now or place their proceeds into ATL or WEB. AccorHotels' offer price is A$3.96 cash per share. Consideration may include a special dividend of up to 23.5c depending on franking credits which will be deducted from the A$3.96. We are buyers of Corporate Travel Management (CTD) following its recent pullback below $20 per share. The highly fragmented nature of the global corporate travel market means there is significant market share opportunities to be realised over time which will drive top line growth. Its technological competitive advantage will drive further growth in margins. While it is great to see Flight Centre (FLT) back delivering solid earnings growth through both improved trading conditions and its Business Transformation Program after a period of weakness, we believe that its strong share price appreciation has already factored in the benefits over coming years.

Telecommunications – a long distance call

We all know that the National Broadband Network (NBN) comes with challenges for consumers and telcos alike. It will be another three years before the NBN rollout is complete and another five years before the last household moves onto the NBN. The NBN compresses earnings so fundamentals for telcos will be challenged for a few more years.

However sentiment is starting to change and this could see share prices rally on a medium-term view despite short-term earnings downside risk.

What has changed recently and is good for telco sentiment is that we are now starting to see commentary from our leaders that the NBN's economic model has problems. At Morgans we have had this view for some time but the new news is that the ACCC and Malcolm Turnbull have recently said as much. At Morgans we think the NBN is a great social investment as it will improve regional internet speeds and drive GDP growth. However we think it's a poor financial investment as we expect lower customer take-up and lower revenue per customer (than the NBN forecasts) due to competing technologies offering better speeds at better prices (sometimes).

To make the NBN work we believe the retail last mile access price needs to be reduced back towards its pre NBN levels of $15 per month (from $43 now and a medium-term target of $52). Should this happen (and the NBN charge a line access fee rather than an access and volume fee), this could remove the last mile congestion that is currently one of the major problems for consumers. However if this happened such an event would, in our view, require a large portion of the NBN's capital base to be written off.

Economics aside, in our view, the NBN was conceived by former Prime Minister, Kevin Rudd, to attract voters and it is equally conceivable, in our view, that our current Prime Minister, Malcolm Turnbull, could write off the NBN to improve the consumer outcome and attract votes. Currently this is all speculation but we did recently move our telco sector view from under-weight to neutral-weight and upgraded Telstra (TLS) to an Add recommendation. We believe TLS is the best way to play this thematic as they have short-term protection (from one-off payments) and upside should the NBN's economics change over the medium term.

For more details contact your advisor or read Regulatory Ramblings Cut Short, NBN Economics Under Inspection, or our most recent Telstra note Plans for Growth and Converging Networks.

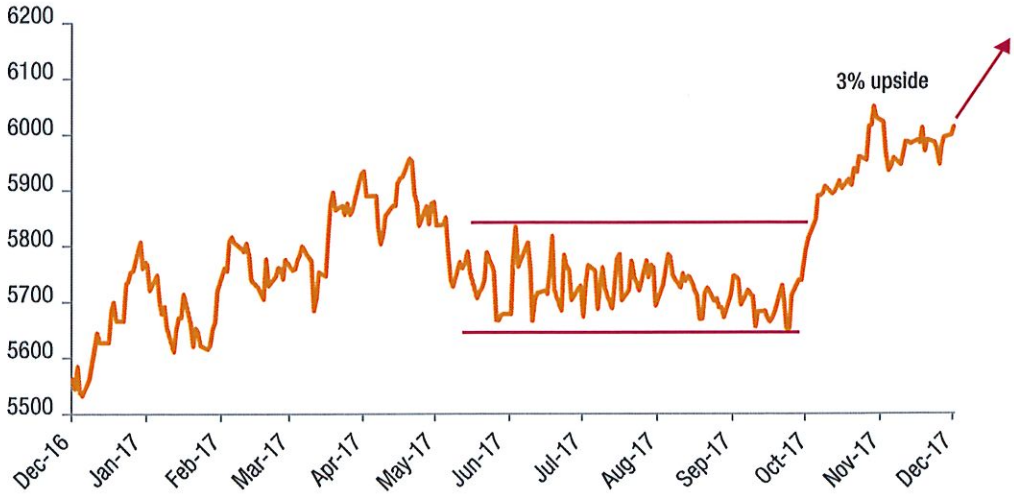
Technical corner – S&P/ASX 200 index (XJO) tracking well

The XJO has been trading in a slow but steady up trend over the past two years which is still firmly intact.

The momentum indicators are constructive and suggest that the primary up trend is still in progress. Although in the short term, the rally from the October 2017 low took a breather, the shape of the current consolidation has bullish characteristics and we are of the view that key resistance of 6052 could be broken in the month(s) ahead.

Our medium term upside price target remains unchanged at 6200.

S&P/ASX 200 Price Index



Source: Factset

Resources – in the middle of a multi-year up cycle

Miners are posting a reasonably strong end to the year, with share prices continuing to enjoy a sustainable improvement in both commodity prices and investor sentiment towards the space. Leading the way has been BHP and RIO, with promises for rising shareholder returns enough to add considerable appeal to income -hungry investors.

We believe that both the turnaround in commodity prices and the rebound in investor sentiment are sustainable (to a large degree at least) and that the resources sector will continue to benefit from both improving earnings power and sector rotation (particularly as some headwinds start to emerge for other sectors, such as banking and retail).

An important factor for the recovery cycle observed in several metals has been a material improvement in supply fundamentals driven by industry reforms that have taken place in China (particularly over the last twelve months). This has impacted related commodity markets, as the more efficient China's productive industries grow (steel mills and manufacturing) the more reliant on imported commodities they typically become (given China's generally low-grade reserves across several key metals).

Commodities have also found support outside of China. The oil price has recovered considerably (on a combination of balanced global supply and deteriorating shale fundamentals) which is supporting our view that the US dollar will re-enter an inflation cycle. This typically drives greater investment demand for physical assets. Not to mention the considerable geopolitical, economic and policy uncertainty undermining confidence across several advanced economies.

We view the current environment (from both bottom-up and top-down) as remaining highly encouraging of investment in the mining sector. Our most preferred mining exposures are **BHP**, **South32** and **OZ Minerals**.

Industrials – opportunities available in the right places

We are mildly optimistic about the Industrials sector in 2018. While higher energy costs and low wages growth are putting pressure on household spending, a rebound in commodity prices and an improvement in export activity will continue to push the Australian economy along. Relief has also been found in the form of a weaker AUD/USD which is making domestic manufacturers more competitive globally. If the currency continues to weaken this will be positive for the Industrials sector, especially for companies with overseas earnings.

Getting exposure to the right overseas markets can often be difficult given each region (and country) has its own pros and cons. In times of uncertainty however we prefer to stick with companies exposed to stable and improving developed markets such as the US and Europe. We also prefer high quality businesses and two that fit the bill nicely are **Orora** and **Reliance Worldwide Corp**. While both have relatively defensive earnings, we also see strong growth prospects in 2018 not only domestically but also in the US where both companies have meaningful exposures. Another company we like is **PWR Holdings** which easily passes the quality test and will also benefit from a lower AUD.

Despite the tough domestic operating environment there are still some sectors that have long-term growth potential. One sector in particular is transport infrastructure (roads and railways) where both the federal and state governments plan to materially boost investment over the next 5-10 years. Australia's growing population and increased congestion, especially in the major capital cities, will require growing infrastructure support and this will likely remain the case in the long term. Stocks that have exposure to this thematic include construction materials companies such as Boral and Adelaide Brighton as well as engineers and contractors such as Cimic Group and Downer.

Healthcare – smoking hot

The larger healthcare names of CSL, Cochlear (COH), and ResMed (RMD) are at or ahead of our price targets suggesting a lot of near-term growth is factored into the share price. However, we maintain our view that all portfolios should hold core positions in these names as they are underpinned by positive long-term thematics of an aging population, medical innovation and government funding support. In order of preference, we like **ResMed** (RMD), **Sonic Healthcare** (SHL), **Ansell** (ANN), and **Healthscope** (HSO). Turning to the emerging healthcare space, there is a lot more activity/volatility. Following favourable regulatory changes, companies operating in the medicinal cannabis (MC) space have enjoyed strong investor support. We always recommend investors look to cover their cost base when share prices have significant runs. In the case of the MC sector, our investment philosophy is no different, especially as the fundamentals are far from clear at this embryonic industry stage, with likely few companies able to survival over the long run. However, we see near-term momentum remaining intact. Looking beyond the MC sector, other names we like in the emerging healthcare space include: **Nanosonics** (NAN), **TPI Enterprises** (TPE), which is turning the corner into profitability and **Impedimed** (IPD), where key study results and product approval are expected shortly.

REIT review

REITs outperformed the broader market during the past quarter supported by falling interest rates. However we expect outperformance will be harder to achieve in 2018 if interest rates lift as expected.

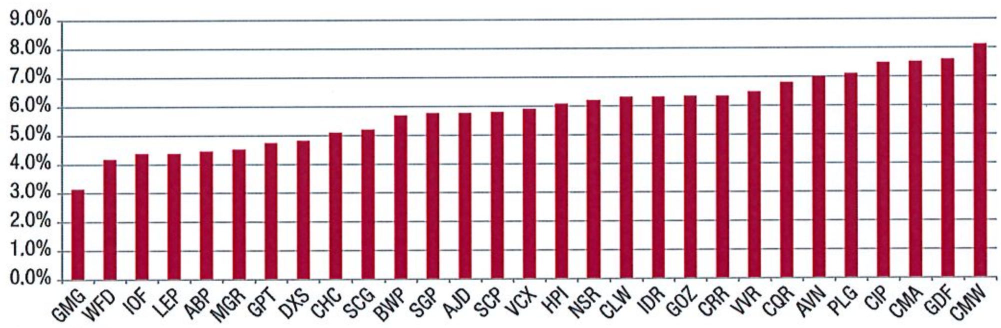
While we expect cap rate compression will moderate during 2018, we note that the Sydney and Melbourne markets remain strong. Quality assets with long lease expiries remain in favour. As a result, direct property acquisitions for many listed REITs remain challenging given current pricing. There is expected to be ongoing strong international demand for Australian real estate assets given the relative yield on offer. We continue to expect some REITs will look at disposing of non-core assets given the cap rates on offer and take the opportunity to recycle capital for development pipelines or apply to debt reduction.

In general, balance sheets remain solid, interest rates remain low (for now) with many REITs now focused on tenor. Following the proposed Westfield Group acquisition by Unibail-Rodamco, we expect further M&A activity in 2018 as well as further share buy-backs. We note this M&A flows on from the UK's largest mall operators (Hammersen and Intu) proposing a merger recently with the key rationale being to increase exposure to higher growth destination shopping centres. We see this as a trend in response to the growing e-commerce platforms/ competition.

We continue to prefer **Aventus Retail Property Fund** (AVN) which offers a FY18 distribution yield of around 7%, with good organic growth available within the existing portfolio, as well as acquisition opportunities in a highly fragmented market. We note there has been some negative newsflow around AVN's largest tenant (9% of income), Steinhoff International. While this will be negative near term given the uncertainty around Steinhoff International's financial position and management team, we remain confident in the overall quality of AVN's portfolio and management team to navigate through this. We would be accumulating on any weakness.

Our other preferred yield plays include: **Viva Energy REIT** (VVR) with distributions underpinned by fixed 3% rental increases until 2025. VVR owns a portfolio of 438 service stations valued at $2.2bn. **Cromwell Property Group** (CMW) has an attractive 8% distribution paid quarterly. We believe the recent sale of its IOF stake was positive as it moved gearing below 40% (and booked a healthy profit). We expect there are further catalysts on the horizon including the listing of its European REIT which will be positive for the Funds Management business.

FY18 Forecast Dividend Yield



Source: Factset

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 add **Senex** (SXY) to the ex-ASX 100 list this month, which we think is ideally positioned to make a material impact on the east coast gas market with two gas projects expected to transform earnings over the next few years. The company has positioned itself exceptionally well, particularly after picking up Project Atlas, which we see as having substantial value upside for the business. We expect to get initial operational results in January (December quarter result) from phase 2 drilling at SXY's West Surat gas project.

Following its strong performance after the recent AGM update, we remove **Bapcor** (BAP) from our High Conviction list this month.

For more refer to our latest High Conviction Stock list published 30 November 2017.

Morgans' High Conviction Stocks

ASX 100

	Ticker	Price	Price Target	FY18 Dividend Yield	FY18 Gross Yield	PE 12mf (x)	12m TSR
ResMed	RMD	$11.27	$11.76	1.7%	1.7%	27.7	6%
Link Administration	LNK	$8.64	$9.04	1.9%	2.7%	19.3	7%
Westpac	WBC	$31.45	$37.00	6.0%	8.6%	12.4	26%
Oil Search	OSH	$7.38	$10.46	2.0%	2.0%	19.8	44%

Ex-100

	Ticker	Price	Price Target	FY18 Dividend Yield	FY18 Gross Yield	PE 12mf (x)	12m TSR
Aventus	AVN	$2.30	$2.47	7.1%	7.1%	13.0	14%
Motorcycle Holdings	MTO	$4.89	$5.57	3.2%	4.5%	19.3	18%
PWR	PWH	$2.37	$3.10	2.8%	4.0%	22.6	35%
Senex Energy	SXY	$0.38	$0.48	–	–	78.4	25%

Source: FactSet, IRESS. Data as at 12 December 2017

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Brisbane Edward Street	+61 7 3121 5677
Brisbane Tynan Partners	+61 7 3152 0600
Brisbane North Quay	+61 7 3245 5466
Bundaberg	+61 7 4153 1050
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New South Wales

Sydney Stockbroking, Corporate Advice, Wealth Management	+61 2 9043 7900
Armidale	+61 2 6770 3300
Ballina	+61 2 6686 4144
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Scone	+61 2 6544 3144
Sydney – Level 7 Currency House	+61 2 8216 5111
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Sydney Reynolds Securities	+61 2 9373 4452
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Victoria

Melbourne Stockbroking, Corporate Advice, Wealth Management	+61 3 9947 4111
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Australian Capital Territory

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Darwin	+61 8 8981 9555

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Hobart	+61 3 6236 9000

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West Perth Stockbroking, Corporate Advice, Wealth Management	+61 8 6160 8700
Perth	+61 8 6462 1999

South Australia

Adelaide	+61 8 8464 5000
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