February 2018

Investment Watch

All set for another solid year

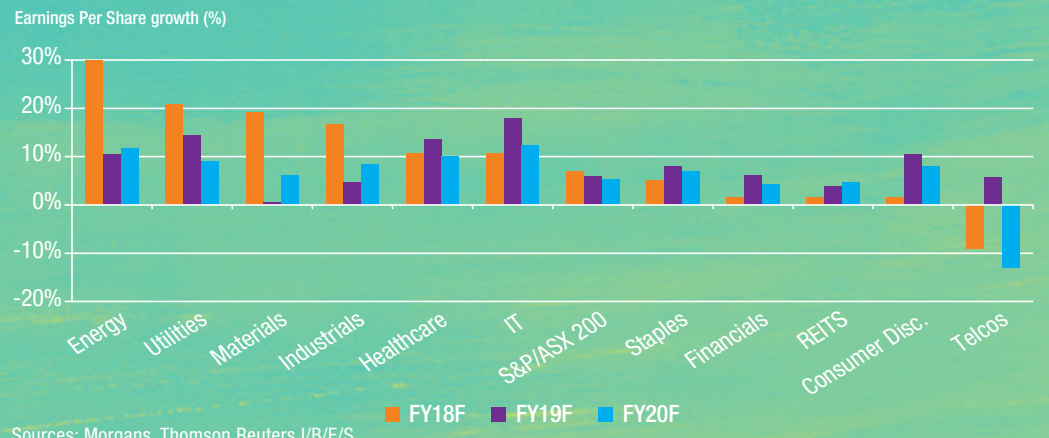
The first half of reporting season kicks off in earnest early February, and according to the latest Thomson Reuters earnings estimates, EPS for the S&P/ASX200 is forecast to grow by 7.0% in FY18, down from 11.3% in FY17. This pace of growth is forecast to continue over the following two years (FY19: 5.9%, FY20: 5.2%) providing a platform for steady equity returns, with stronger global growth and improving business conditions offering the upside.

Positive business and consumer sentiment sets the tone for reporting season and investors have responded by putting capital to work. The European resurgence and the Trump-led economic reforms in the US are poised to continue to buoy the ASX, in particular offshore earners. While Australian economic growth is improving, offshore markets continue to set the pace for an economic rebound.

Economic fundamentals are still signalling support for growth assets in coming months. Even allowing for the positive outlook, valuations are expensive across many asset classes, we prefer to err on the side of caution and take profits where we think prices have run ahead of fundamentals. We look for evidence that improving business and consumer sentiment is beginning to translate into meaningful earnings tailwinds for businesses.

This month we preview the 1H18 reporting season and highlight themes to watch as investor sentiment turns around and confidence returns to the corporate sector (Page 3). Following the momentous decision to slash tax rates in the US, we look at the implications for equity markets and what we can expect from the US economy this year (Page 2). We also dive into two sectors that have been in and out of favour with the market in recent times: Telco and Agri/Food (Page 4).

Outside of the structurally challenged sectors, ASX 200 earnings growth looks robust



Sources: Morgans, Thomson Reuters I/B/E/S

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Economics – what we can expect from the US economy

The Corporate Tax cuts that were passed into law at the end of 2017 begin a period of sustained structural growth in the US economy.

There have been only two such periods of US growth previously since WWII. The first was after the tax cuts of the 1960s introduced by the Kennedy/Johnson administration. The second was after the tax cuts of the 1980s introduced by the Regan/Bush administration. In both of these cases corporate tax cuts generated sustained levels of higher corporate investment and higher economic growth. In both of these cases this resulted in lower unemployment and higher living standards. In each case, this improvement in employment and living standards was sustained over the following decade.

The result of the Trump tax cuts should introduce a similar period of sustained growth in the US economy. Corporate investment will be stronger over a series of business cycles. Unemployment will be lower over a series of business cycles. Wages growth and improvement in the standard of living will be higher over a series of business cycles.

We experienced a very deep recession in 2008 followed by one of the longest expansions in US history. What we can expect from now on are much more shallow and shorter business cycles. Rises in unemployment as the US economy slows down will be less. This will generate a smaller stock of US unemployment to be absorbed in the next cycle of expansion. This means that business cycle expansions will be shorter. Thus, growth in living standards will be sustained over a series of business cycles. This is the kind of cyclical behaviour previously seen in the US economy in the 1960s and again in the 1980s.

Our current estimate is that US corporate tax cuts should increase US after tax corporate earnings by around 12%.

We think that growth in the US economy will accelerate from 2.3% in calendar 2017 to 2.7% in 2018. Growth should slow slightly to 2.5% in 2019. As a result of that continued strong growth, unemployment should continue to fall through 2018 until it reaches a low of around 3.8-3.9% by mid-year. This very low level of unemployment will be equal to levels not previously seen since the beginning of this century. This low level of unemployment will generate a shortage of labour coming forward to fill the demand for employment. The shortage will then generate an increase in wages growth which will rise quarter-by-quarter. This higher increase in wages growth will then put sustained upward pressure on core inflation.

The result of higher wages growth and higher core inflation will be a more rapid rise in the Fed Funds Rate (FFR) than currently expected. We think that the FFR will be tightened four times in calendar 2018 and another four times in 2019.

One of the mysteries that appears to be currently besetting the market is why it is with such an outlook for a tightening FFR do we see a falling US dollar. This lack of understanding of the weak US dollar is because of the lack of attention that has been paid to fiscal stimulus.

The cut in US corporate tax rates is achieved in part by an increase in the US budget deficit of around 0.75%. This expansion of the US budget deficit adds stimulus to the economy that more than compensates for all of the rate hikes in 2018. If we take fiscal policy and monetary policy together there is no tightening of demand policy in the US economy in 2018. Demand conditions are much easier than is commonly understood. These easier demand conditions are leading to a higher US current account deficit and a lower US dollar.

Our current estimate is that US corporate tax cuts should increase US after tax corporate earnings by around 12%. These higher earnings will be reported quarter by quarter as we move through calendar 2018. This upward pressure on US corporate earnings should generate continuous upward pressure in the US equity market in the quarters ahead.

Equity strategy – on track for a solid season

Positive business and consumer sentiment sets the tone for the February reporting season and investors have responded by putting capital to work.

The first half of reporting season kicks off later this week, and according to the latest Thomson Reuters earnings estimates, EPS for the S&P/ASX200 is forecast to grow by 7.0% in FY18, down from 11.3% in FY17. This pace of growth is forecast to continue over the following two years (FY19: 5.9%, FY20: 5.2%) providing a platform for steady equity returns, with stronger global growth and improving business conditions offering the upside. In our view the sectors best placed for upside surprise this reporting season include Resources, Offshore Earners and Retailers.

Valuations set a high bar for market darlings and growth stocks

Elevated valuations will again set a high bar for growth stocks and unless earnings upgrades are likely, we prefer to err on the side of caution and take profits where we think prices have run ahead of fundamentals. We look for evidence that improving business and consumer sentiment is beginning to translate into meaningful earnings tailwinds for businesses. What concerns us is the magnitude of the divergence between high PE and low PE industrial stocks. The spread is the widest it's been in 5 years, and we think February will be the reality check the market needs to bring valuations back into line. We prefer industrial stocks where we identify upside risk to earnings and guidance (CTD, RWC, JBH).

Offshore earners to benefit from the global recovery

The European resurgence and the Trump-led economic reforms in the US are poised to continue to buoy ASX offshore earners (CTD, RWC, ATL). While Australian economic growth is improving, offshore markets continue to set the pace for an economic rebound. We expect to see companies further clarify the extent of the US tax reform benefits via their results.

Resources – commodities recovery doing the heavy lifting

Resources stocks offer upside risk to dividend expectations given key commodity prices (oil, iron ore, coal) have traded well above consensus expectations through late 2017. Bulk commodity miners (BHP, RIO, FMG, WHC) offer best upside capital management potential.

Tactical positioning into February

We think that avoiding the downside is as important as identifying the upside in the current market. Below we flag key candidates for potential upside and downside reactions to February results relating to reported earnings, outlook statements, capital management and/or other catalysts.

For more refer to detailed **Reporting Season Preview** published 29 January 2018

Reporting season potential hits and misses

Catalyst	Stocks
Earnings beat / upgraded outlook	Corporate Travel, CML Group, Reliance Worldwide, JB Hi Fi, Lovisa, Adairs, Apollo Tourism
Dividend beat / capital management	BHP, Rio Tinto, Fortescue, Whitehaven, IAG
Earnings miss / softer outlook	Healthscope, Primary Health Care, Amcor, Regis Healthcare, Silver Chef, Domino's Pizza
Possible weakness is a buying opportunity	Amcor, Domino's Pizza, CSL
Overvalued / vulnerable / sell	Blackmores, Bega Cheese, Sandfire

Telecommunications – the tide is turning

We are increasingly turning positive on the broader telecommunications sector and have been progressively upgrading our recommendations and sector view. For the last three calendar years Telco has underperformed the ASX 200 accumulation index and over the last two it has underperformed by more than 20% pa. That said, there have been pockets of strength with NEXTDC being the star performer over 2016 and 2017, up 53% and 65% respectively. Broadly speaking, tides eventually turn, and we now think that investors are being overly pessimistic on the sector which creates a buying opportunity.

The NBN has been at the core of telco sector weakness (as telcos make as much as a third of profit on NBN). We continue to hold the view that the National Broadband Network (NBN) is a good social infrastructure but a poor financial investment and that it will eventually be written down. If and when the NBN eventually gets written down consumers and telcos alike will be far better off and this could be the catalyst to see the sector re-rate. We believe that Telstra is best positioned to weather the NBN storm as they receive one-off payments over the next few years while continuing to invest into their next generation 5G mobile network and we think patient investors will ultimately be rewarded.

Data Centre and connectivity remains a major technology trend and continues to grow at a rapid rate. We believe NEXTDC and Megaport both offer investors an attractive way to invest alongside key thematics including connectivity between Cloud Computing, Big Data, Artificial Intelligence and more broadly growing digitisation and connected devices. Megaport offers this on a global basis as the largest data centre connected platform globally (operating in 185 data centres globally) and NEXTDC as one of the premier data centre operators in Australia. **Telstra**, **Megaport** and **NEXTDC** are our key picks for the year ahead.

For more refer to our updated Telco sector note **Feb 2018 market check and results preview** published 1 February 2018

	Ticker	Price	Price Target	Dividend Yield	12m TSR
Megaport	MP1	$3.87	$4.44	–	15.6%
NEXTDC	NXT	$5.74	$6.25	–	8.9%
Telstra	TLS	$3.64	$4.11	6.1%	13.4%

Source: Morgans, Iress. Data as at 31 January 2018

Food and Ag – strong demand offsets regulatory risk

The outlook for Chinese consumer demand for Australian food products remains positive. In 2017, investors welcomed the Chinese government's more supportive regulatory environment in the all-important cross border e-commerce channel (CBEC). The prospect of strong, China-led growth as individual companies progressed their expansion plans propelled share prices to record levels. In particular, the strong gains reported by ASX listed infant formula (IF) companies has dominated media headlines.

Looking forward to the year ahead, those wishing to sell Chinese labelled IF product into China bricks-and-mortar stores now require CFDA registration. We expect CFDA registration will provide long-term market share opportunities for those successful as IF brand rationalisation occurs in this very large market. Of the ASX listed IF players, only A2M has secured CFDA registration. Within our coverage universe, Bellamy's Australia (BAL) has lodged its CFDA application and we expect it to receive registration by the end of June 2018, while we will look for an update from Bubs (BUB) at its interim result at the end of February. In the short term, updates on CFDA applications are potential share price catalysts.

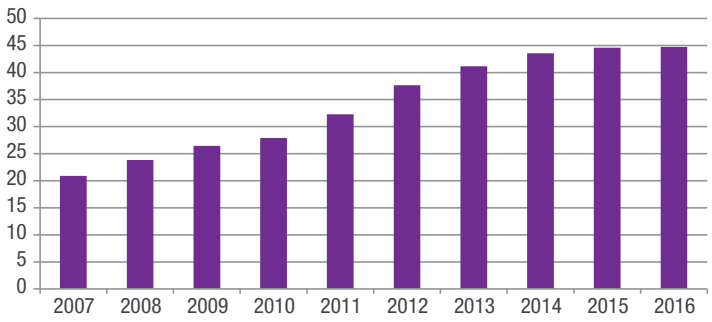
We remained cautious heading into the CFDA deadline given the possibility of channel-stuffing and subsequent discounting by those without registration. Against the backdrop of elevated valuations, the added uncertainty around proposed regulatory changes in the CBEC was further ground for conservatism.

However, our concerns of short-term trading volatility were eased by A2 Milk's strong trading update at the end of November and BAL's material earnings guidance upgrade in January. In addition, our industry feedback suggests significant regulatory changes in the CBEC are unlikely given the importance e-commerce platforms hold in China. We understand the CFDA registration process was implemented to ensure Chinese consumers receive safe food products. As a result, we recently upgraded **BAL** to an Add rating. However, such is the tendency of China-leveraged stocks, it has already exceeded our price target.

The expected stability in the CBEC should also have positive implications for Blackmores (**BKL**). Although in our view, the fundamentals of the vitamin category are not as favourable as IF. We believe vitamins are more susceptible to brand substitution, where consumer purchasing decisions are driven more on price and as a result, it should trade at a discount to IF peers. In our view, BKL has run ahead of its near-term fundamentals.

For more refer to our recent note upgrading Bellamy's **"The Comeback Kid"** published 16 January 2018

Global infant formula sales (USD, bn)



Source: Euromonitor, Bellamy's Australia, Morgans

Technical corner – APA Group and Macquarie Atlas Roads

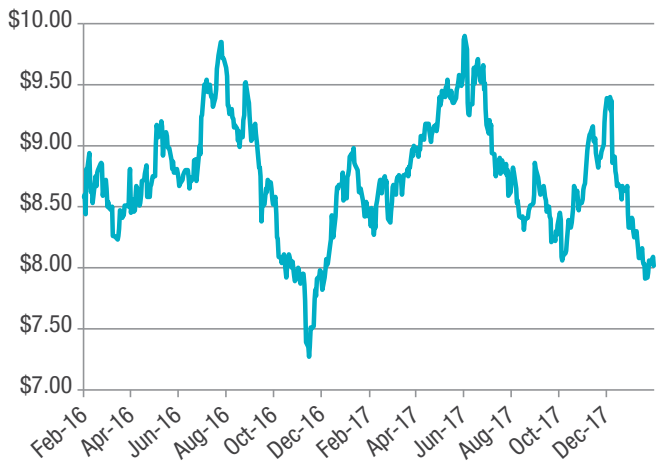
APA Group (APA)

- APA has been trading in correction mode since June 2017 which might be approaching a turning point. The price has bounced over the past few weeks and we are of the view that the correction is likely to be over.
- The RSI and the MACD indicators have turned positive from oversold territory suggesting that the price is likely to bounce in the short term.
- APA exhibits among the most bond-like characteristics of the utilities/infrastructure stocks, hence recent weakness is unsurprising. APA now looks too cheap relative to its reliable dividend yield (5.6% FY18) and our fundamental valuation (8% discount). We also recently increased our position in APA to 5% in our Income Portfolio.
- The potential upside price target is $8.80. We are comfortable to accumulate the stock around current price levels.

Macquarie Atlas Roads (MQA)

- MQA has been trading in an up trend over the past year which is still firmly intact.
- The recent pull back retraced to its long term up trend line crossing that $5.70 where initial buying interest is likely to arise.
- The momentum indicators have turned positive from oversold territory suggesting that the price is likely to rally in the short term. The first potential upside price target is $6.40, however this level could be exceeded.
- Fundamentally MQA has been sold off recently due to an increase in government bond rates and process of internalisation currently underway.
- Fundamentally we expect an update on internalisation by the April AGM – uncertainty over fee leakage to Macquarie and its potential funding are short-term headwinds but internalisation is a positive outcome for investors.

APA Share Price



Source: IRESS

MQA Share Price

Source: IRESS

Congratulations – to our award-winning Analysts

Top earnings estimators

Category	Rank	Industry	Analyst
Industry	1	Telecom Services & Information Technology	Nick Harris
Industry	1	Transportation Infrastructure	Nathan Lead
Industry	2	Food, Beverages & Tobacco	Belinda Moore
Industry	3	Telecom Services & Information Technology	Ivor Ries

Top stock pickers

Category	Rank	Industry	Analyst
Industry	2	Transportation Infrastructure	Nathan Lead
Industry	3	Financial Services	Azib Khan


Nick Harris


Nathan Lead


Belinda Moore


Ivor Ries


Azib Khan

Banks – enough to be excited about

We believe the major banks sector as a whole presents good value at current share prices and for this reason we have an Add recommendation on all four majors.

Some of the value in the major banks is attributable to a heightened regulatory risk premium in our view. This is particularly stemming from the announcement of a Royal Commission (RC). Our base case is that the RC will not ultimately result in capital raisings or dividend cuts.

We expect the asset quality environment to remain benign over the next 12 months, creating scope for upside risk to earnings forecasts despite the cost of risk (credit impairment charge as a percentage of the loan book) for three of the four major banks hovering at cyclically low levels. We expect net interest margins to generally expand from 2H17 to 1H18F, which together with recently improved consumer sentiment and with interest-only home loan flows having re-based, will be supportive of income growth. Investment spend is being increasingly focused on digitisation and automation, and is resulting in increased focus on headcount reduction, which places the sector in a good position to achieve positive jaws on an underlying basis.

We expect the cost of equity capital (COEC) being factored into major bank share prices to reduce as a result of reduction in perceived RC-related regulatory risk over the next year. Our base case is that the RC will not ultimately result in customer redress large enough to warrant capital raisings or

dividend cuts as the banks are now largely in comfortable CET1 capital positions. We are therefore of the view that share price weakness stemming from RC-related risk presents a good opportunity to buy yield. There is also reason to believe that the RC marks the peak of regulatory risk for the Australian major banks, particularly with some members of the Council of Financial Regulators (CFR) reportedly suggesting to the Federal Treasurer that politicisation of the banking sector has now gone too far.

The major banks, with the exception of NAB, have largely completed their capital builds. Furthermore, we are of the view that the Basel III reforms finalised last month do not pose a threat to the 'unquestionably strong' regulatory capital framework announced by APRA last year. These factors create scope for capital returns from ANZ, CBA and perhaps even WBC. We believe there is strong potential for further divestments to be announced this year, which would increase the scope for return of capital to shareholders.

Ranking	Stock	Recommendation	Share Price	Target Price	Previous Target Price	Dividend Yield	Gross Yield	12m Forecast TSR
1	WBC	ADD	$31.42	$36.00	$37.00	6.1%	8.8%	25%
2	NAB	ADD	$29.30	$33.50	$34.50	6.8%	9.7%	25%
3	ANZ	ADD	$28.90	$30.00	$30.00	5.6%	8.0%	13%
4	CBA	ADD	$80.01	$81.50	$80.00	5.5%	7.8%	11%

Source: Morgans, Iress. Data as at 31 January 2018

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**

As we look ahead to reporting season, markets remain in a sweet spot with global growth becoming entrenched and inflation still conspicuously absent. However with multiple and probable geopolitical risks knocking on the doorstep, we think this 'goldilocks' environment is unlikely to continue and volatility will make a return.

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 identify those stocks that we think offer the highest risk-adjusted return through 2018.

We add **Corporate Travel Management** to the High Conviction list this month and remove Motorcycle Holdings and Aventus Retail Property Fund.

For more refer to our latest **High Conviction Stock list** published 1 February 2018.

Morgans' High Conviction Stocks

ASX 100

	Ticker	Price	Price Target	FY18 Dividend Yield	FY18 Gross Yield	FY18 PE (x)	12m TSR
ResMed	RMD*	$12.49	–	–	–	–	–
Link Administration	LNK	$8.92	$9.04	1.9%	2.7%	19.7	4.4%
Westpac	WBC	$31.12	$36.00	6.1%	8.8%	12.2	17.5%
Oil Search	OSH	$7.57	$10.46	1.8%	1.8%	23.1	47.9%

Ex-100

	Ticker	Price	Price Target	FY18 Dividend Yield	FY18 Gross Yield	FY18 PE (x)	12m TSR
Corporate Travel Management	CTD	$20.23	$23.00	2.0%	2.8%	24.7	17%
PWR	PWH	$2.56	$3.10	2.6%	3.8%	22.8	25%
Senex Energy	SXY	$0.38	$0.48	–	–	nm	25%

Source: FactSet, IRESS. Data as at 31 January 2018

* Under Review

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