Investment Watch

June 2018

Welcome

We put the Federal Budget under the spotlight this month and look at what it means for taxpayers and the equity market. Higher commodity prices and improving terms of trade have helped take some pressure off the nation's finances. We look at the outlook for GDP growth and what we can expect from the economy over the next few years. As the market moves through its seasonally weaker period, we identify opportunities for investors that have a longer time horizon in our High Conviction list.

Recently published research

- CBA – Expense risk is materialising (9/5), ADD
- AMP – A mixed quarter (10/5) ADD
- Aristocrat – On a roll (24/5), ADD
- Reliance Worldwide – Taking over the world (24/5), ADD
- Telstra – Tough luck if you want to phone a friend (25/5), ADD

In this issue indicates published research available online.

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BKI Investment Company Limited entitlement and general offer

BKI Investment Company Limited is undertaking an Entitlement and General Offer to raise up to approximately $202.2 million.

Entitlement Offer – non-renounceable pro-rata entitlement offer to all eligible shareholders of 1 new share for every 15 existing shares held at 7:00pm on the record date at $1.50 per share to raise approximately $62.2 million.

General Offer – an offer to existing and new shareholders for up to 93,351,184 new shares at $1.50 per share to raise up to approximately $140.0 million.

Offer Price
$1.50 per share

Record date for Entitlement Offer
Monday, 14 May 2018

Closing date for Entitlement Offer
Tuesday, 12 June 2018

Closing date for General Offer
Thursday, 14 June 2018

Morgans is a Co-Manager to the Offer.

BKI INVESTMENT COMPANY LIMITED

View offer details
www.morgans.com.au/BKI

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Economics – the Australian budget emerges from 'dog days'

The period from 2012 to 2015 was Australia's 'dog days'. Our 'dog days' were when declining commodity prices led to a decline in the terms of trade.

This decline in the terms of trade led to low nominal GDP growth. Low nominal GDP growth put tax revenue under great pressure. This meant expenditure needed to be tightly controlled to stop the budget balance blowing out.

In Figure 1, we see the outlook for the Australian economy from the budget papers. What is interesting here is the bottom line - nominal GDP. In previous commentary, we have noted that nominal GDP growth in our 'dog days' from 2012 to 2015 was really only around 2%. Nominal GDP is how wages are paid which meant that wage growth was pretty miserable. Nominal GDP is also how corporate profits are paid. This also meant that corporate profits were paltry.

Nominal GDP increased from around 2% figure in the previous three years to 5.9% in 2016-2017. This figure also shows that nominal GDP is expected to rise by 4.25% in 2017-2018. Treasury expects it to increase by 3.75% in 2018-2019 and then 4.75% in 2019-2020. In the two years after that, nominal GDP continues to grow at 4.5%. The recovery in nominal GDP rescues Australia from its 'dog days'. Faster nominal GDP growth rescues us from the misery of that period. It also means that tax revenues are now rising at a pace where governments can fund things like individual tax cuts as long as they keep a steady line on budget expenditure.

In Figure 2, we see the reason that nominal GDP recovered. The real cause of our 'dog day' period was the decline in commodity prices and the decline in the Australian terms of trade from 2012 until 2015. It is this decline which inflicted low nominal GDP growth on the Australian economy.

Since the beginning of 2016, we have seen a sharp recovery in commodity prices. The RBA index of our export commodity prices has risen more than 20%. The terms of trade has had a similar but slightly smaller recovery. The Australian Treasury thinks the terms of trade will drift down from now on. We have a whole lot of reasons including the expanding US budget deficit for thinking that Australian export commodity prices are going to be stable or continue to rise.

What this budget does

The centrepiece of this budget is the provision of individual personal tax cuts (explained in more detail on pages 4-5). This is achieved through a seven-year personal tax plan. The total cost of these tax cuts is estimated at $13.4 billion. These tax cuts are possible because rising commodity prices have generated rising nominal GDP growth which is generating rising revenue.

Conclusion

The Australian economy has now emerged from its 'dog days'. During this period, falling commodity prices generated slow nominal GDP growth and slow government revenue growth. The only solution to this period was a tight control on spending.

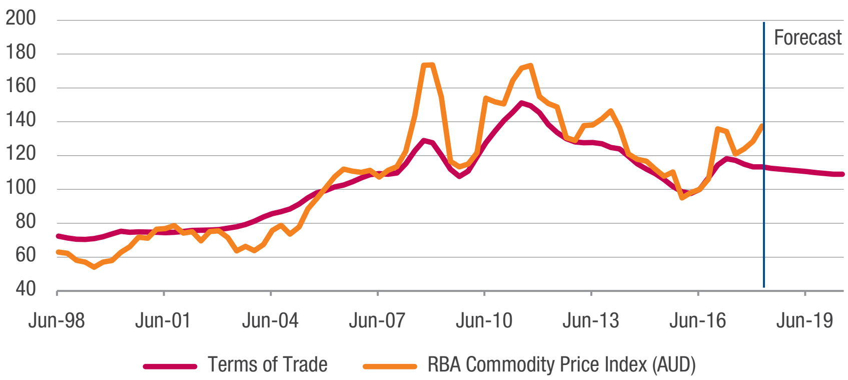
A recovery in commodity prices and a rise in the terms of trade has now generated faster nominal GDP growth and faster government revenue growth. The government can now afford to return that faster government revenue growth to the voters in terms of prudent tax cuts.

Good luck is being accompanied by good management.

The budget combines good luck with good management

For more refer to our Economics research piece published 8 May

Figure 2 – Commodity prices and the terms of trade



Source: Budget Paper No 1, Chart 8, Page 2-24

Figure 1 – Major Economic parameters

	Outcomes		Forecasts		Projections	
	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Real GDP	2.10%	2.75%	3.00%	3.00%	3.00%	3.00%
Unemployment rate	5.60%	5.50%	5.25%	5.25%	5.25%	5.00%
Consumer price index	1.90%	2.00%	2.25%	2.50%	2.50%	2.50%
Nominal GDP	5.90%	4.25%	3.75%	4.75%	4.50%	4.50%

Source: ABC cat. No. 5206.0, 6202.0, 6345.0, 6401.0 and Treasury

Note: Year average growth unless otherwise stated. The unemployment rate is the rate for the June quarter. The consumer price index is through-the-year growth to the June quarter.

Equity strategy

Winners and losers from the budget

The 2018-19 budget builds on the last with increased commitments to infrastructure and lower taxes for businesses and individuals. While there is a little bit for everyone, there is little doubt that it is an election budget designed to appeal to the mainstream voter, and clearly demonstrated by the Coalition's cornerstone proposal to provide immediate tax relief for middle-low income earners and offering very few expenditure cuts.

We summarise the key proposals for investors:

Economy doing the heavy lifting

Strong employment growth and higher tax receipts have reversed the fortunes for the underwhelming budget position from a year ago. The budget is expected to return to surplus a year earlier than expected. Higher than expected commodity prices and tax receipts coupled with some fiscal restraint will see the budget return to a $2.2bn surplus in 2019-20. In our view, this will allay some of the concerns raised by rating agencies over the past two budgets and reaffirm Australia's AAA rating.

Few unpleasant surprises for the equity market

Unlike the past few Coalition budgets where the focus has been on budget repair and fiscal restraint, few announcements have the potential to shake the confidence in the equity market this time around. The biggest positive for the market is the additional commitment to infrastructure where the budget again surprised on the upside. On the whole, some income tax relief and increases in infrastructure spending should reinforce the confidence that there is finally some fiscal response to a period of below-trend economic growth.

Older Australians set to reap the rewards

A number of positive announcements were made to benefit baby boomers including: increased funding for home-care support, incentives for older Australians to stay in employment and start new businesses, and the pension loan scheme has been expanded to allow retirees to borrow against the value of their home up to the value of their age pension.

Current 2017/18 Marginal Tax Rates

Current 2017/18 Marginal Tax Rates

Income Range	Tax Rates
Up to $18,200	0%
$18,201 - $37,000	$0 + 19% over $18,200
$37,001 - $87,000	$3,572 + 32.5% over $37,000
$87,001 - $180,000	$19,822 + 37% over $87,000
$180,001	$54,232 + 47% over $180,000

Proposed 2018/19 Marginal Tax Rates

Income Range	Tax Rates
Up to $18,200	0%
$18,201 - $37,000	$0 + 19% over $18,200
$37,001 - $90,000	$3,572 + 32.5% over $37,000
$90,001 - $180,000	$20,797 + 37% over $90,000
$180,001	$54,097 + 47% over $180,000

Proposed 2023/24 Marginal Tax Rates

Income Range	Tax Rates
Up to $18,200	0%
$18,201 - $41,000	$0 + 19% over $18,200
$41,001 - $120,000	$4,332 + 32.5% over $41,000
$120,001 - $180,000	$30,007 + 37% over $120,000
$180,001	$52,207 + 47% over $180,000

Proposed 2024/25 Marginal Tax Rates

Income Range	Tax Rates
Up to $18,200	0%
$18,201 - $41,000	$0 + 19% over $18,200
$41,001 - $200,000	$4,332 + 32.5% over $41,000
$200,001	$56,007 + 47% over $200,000

Some help for the cautious consumer

We see a small net benefit for the consumer through the scrapping of the Medicare levy uplift and lowering the effective tax rate for low income earners. Negligible real wages growth and a high level of household debt will mean that the tax relief will likely be absorbed in housing-related expenditure.

Winners and losers from Superannuation and Pension changes

Some clear positives emerge for **Challenger**, requiring Superannuation fund trustees to offer retirement income products. This should grow overall demand for annuities. New means testing rules will also enable the development of new retirement income products including deferred annuities. The proposal to automatically move inactive super accounts under $6000 to taxpayer's active super account will hit Link Administration's Fund Administration business.

Infrastructure top-up

An additional $24.5bn infrastructure package to fund road and rail projects including $14bn along the East Coast. Notable projects include a new $5.1bn Melbourne Airport rail link, $1bn Brisbane to Gold Coast M1 upgrade, $800m in new Bruce Highway upgrades, WA road and rail commitments totalling $3bn, and $1.5bn in road and rail upgrades for South Australia. The ramp up in infrastructure spending should support tendering opportunities for suppliers, engineers and contractors (**Wagners**, **Boral**, **Cimic**, **Downer**, **Adelaide Brighton**, **Acrow**).

Personal Income Tax Seven Year Plan

A total of $13.4bn in personal income tax cuts were announced. The changes take place over seven years in three phases through a combination of bracket simplification and rate adjustments:

Proposed Tax Offset Changes

Tax Offset	Maximum Offset
FY17/18 Low Income Tax Offset	$445
FY18/19 Low Income Tax offset	$445 plus
Additional Tax Offset*	$530 (or $1,060 per couple)
FY22/23 Low Income Tax Offset	$645

* Additional tax offset available up to FY2021/22

- From 1 July 2018 the 32.5% top threshold will increase to $90,000.
- From FY2018-19 through to FY2021-22 a new tax offset of $530 will be available for low and middle income earners in addition to the Low Income Tax Offset (LITO) of $445.
- From 2022-23 the 19% top threshold will increase from $37,000 to $41,000; and the LITO of $445 will increase to $645.
- From 2022-23 the 32.5% top threshold will increase to $120,000.
- From 1 July 2024 the 37% tax bracket will be abolished completely, reducing the number of tax brackets from five to four; and the top marginal tax rate of 47% will apply to incomes above $200,000.
- The above changes will ensure Australians earning more than $41,000 will only pay 32.5% up to the top marginal tax rate; and will address tax bracket creep for the future.

Conclusion

Ongoing tax reform and increased fiscal spending in infrastructure is healthy in our opinion, particularly as the Australian economy transitions in a period post peaks in mining investment and housing. Seeking to re-balance equity in the tax system and stimulating growth as the nation's circumstances change shouldn't disagree with the aim of creating a more efficient and market friendly economy. However given the long lead-time before implementation of personal (seven years) and business (ten years) tax reforms, we'll have to wait and see whether the plans become reality.

While we are pleased that government spending has been reined in to some extent, there's not enough in the budget, in our view, to bring about significant upside revisions to corporate earnings – a key ingredient at a time when Australian shares already look extended giving local investors more reason to be cautious in coming months in our view.

A total of $13.4bn in personal income tax cuts were announced.

For more detail, refer to our published report **2018 Federal Budget Summary**

Fixed Interest – new opportunities

There have been two exciting new issuances for income investors in FY18 with the listing of the MCP Master Income Trust (MXT) and the recent listing of the Gryphon Capital Income Trust (GCI).

Both trusts offer investors monthly income and more importantly provide diversification away from ASX listed Additional Tier 1 Hybrid securities which make up the bulk of the listed investable universe for retail investors.

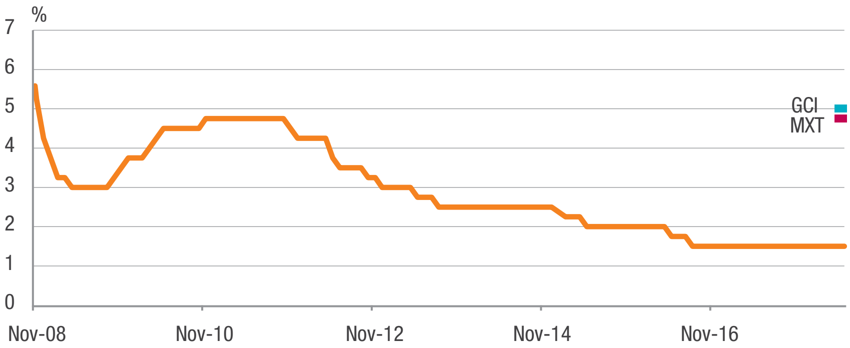
MXT provides investors with direct exposure to the Australian corporate loan market, a market which is dominated by regulated banks and is largely inaccessible to non-bank investors. The trust specialises in direct lending and private debt market investments. The targeted return for the Trust is the RBA Cash Rate plus a margin of 3.25% which currently equates to a return of 4.75% per annum.

GCI on the other hand invests in a portfolio of Australian asset backed securities (ABS) including residential mortgage backed securities (RMBS). The Trust listed in May following the issuance of $176m worth of units to investors. It has a targeted return of 3.50% above the RBA Cash Rate which results in a current target return of 5.00% per annum.

We believe both securities have a home in a diversified income portfolio and expect investors will be attracted to the monthly income as well as the track record of the managers of the trusts. Since listing MXT has traded up slightly on the NTA and we would anticipate as investors become more comfortable with GCI it will likely trade up in price as well. We have Add ratings on both trusts and they both feature in our Cross Asset Model Income Portfolio.

For more detail refer to our published report **Fixed Interest Weekly**

RBA Cash Rate



Source: RBA, Morgans

Healthcare – notes from the budget

Big winners from the budget include older Australians, with a substantial aged care package offering a number of positive announcements made to benefit these Baby boomers including:

Increased funding for home-care support with A$1.6bn committed; this measure is forecast to help 14,000 access home-care support packages which provide up to A$50,000 worth of subsidised services. However, with A$20bn spent on aged-care already and at least 100,000 people on the waiting list for an aged care package, the initiative, while a step in the right direction, is really a drop in the ocean. We see modest benefit for retirement village operators (**Aveo**, **Eureka**, **Ingenia**) and with no funding cuts in this budget, we also see a modest benefit for aged care operators (**Japara**, **Regis Healthcare**, **Estia Health**).

Incentives to stay in employment and start new businesses with an expanded Work Bonus program allowing up to A$300 without impacting pension payments.

A$102.5m committed to improve the access to psychological support (it is well known that mental health issues in older people are under-diagnosed; men > 85 have the highest risk of suicide of all age groups).

Expanded the Pension Loan Scheme to allow all retirees to borrow against the value of their home up to the value of their age pension.

Other notable announcements:

- A new A$1.3bn health and medical research growth plan, including A$500m to prioritise emerging study of genes and their functions. A positive for the biotech space.
- Overhaul of the R&D tax incentive to save A$2bn over the next four years by better targeting the program and improving its integrity and fiscal affordability. A net positive across the biotechnology sector.

High Conviction Stocks

Overall economic growth is still supportive for equities, and we currently expect the ASX200 to edge higher to 6200 by year-end. But the outlook, particularly this late in a sustained global business cycle, is becoming more vulnerable to various risks, notably higher bond yields and geopolitical risks.

Benefiting from a strong turnaround in top-down fundamentals, we remove BHP Billiton this month as the stock recently hit our price target. We also remove Link Administration as some unfavourable regulatory risks emerge.

Refer to our latest High Conviction Stock list published 4 June 2018 **www.morgans.com.au/stockpicks**

ASX 100	Ticker	Price	Price Target	FY19 Dividend Yield	FY19 Gross Yield	FY19 PE (x)	12m TSR
Cleanaway	CWY	$1.65	$1.68	2.1%	2.9%	24	5%
Suncorp	SUN	$13.45	$14.65	5.7%	8.0%	14	18%
Westpac	WBC	$27.74	$35.00	6.9%	9.8%	10	36%
Ex-100	**Ticker**	**Price**	**Price Target**	**FY19 Dividend Yield**	**FY19 Gross Yield**	**FY19 PE (x)**	**12m TSR**
CML Group	CGR	$0.56	$0.63	4.5%	6.4%	12	19%
PWR	PWH	$2.64	$3.10	3.0%	4.3%	20	22%

Source: FactSet, IRESS, Data as at 3 June 2018

Indicates published/linked Research Note

Recent initiations

A2 Milk
ADD PT A$14.40
A2M produces premium branded dairy nutritional products that have perceived health benefits in its targeted markets being Australia, NZ, China, UK and USA.

Cooper Energy
ADD PT A$0.44
COE is a gas producer gas in South-East Australia. The company's interests are spread across onshore and offshore exploration and production of gas and gas liquids.

Smiles Inclusive
ADD PT A$1.40
SIL owns and operates centres through the Totally Smiles Dental Group. SIL's model allows for a continued economic interest for practitioners after acquisition.

Costa Group
HOLD PT A$7.57
CGC is the market leader in Australia's horticulture industry, with an integrated portfolio of high-value produce categories leveraged to strong consumer demand.

Technical corner

QBE Insurance

- QBE has been trading in a down trend over the past year which remains firmly intact.
- The current short term down swing has approached its key support of $9.22 where initial buying interest is likely to arise. The RSI and the stochastic indicators have reached oversold territory suggesting that the price is likely to bounce in the short term.
- The first potential upside price target is $10.20 however the price could overshoot to $10.40.

QBE Price Chart

Source: IRESS

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Bundaberg	+61 7 4153 1050
Cairns	+61 7 4222 0555
Caloundra	+61 7 5491 5422
Gladstone	+61 7 4972 8000
Gold Coast	+61 7 5581 5777
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