# Investment Watch

July 2018



morgans

# Welcome

Record low interest rates and surging demand from offshore investors have doubled house prices in Sydney over the last 10 years and increased prices more than 75% in Melbourne. Regulatory change, softening investor demand and low wage growth have put the brakes on prices and taken a hit to consumer sentiment. We look at the implications for the Retail and Banks sector this month. In a directionless market lacking conviction, we also highlight our best ideas ahead of reporting season.

### Recently published research

- Ramsay Health Care – A demand side issue (21/6), ADD
- Bellamy's Australia – Strengthening the provenance story (21/6) HOLD
- Telstra – Is FY19 rock bottom? (21/6), ADD
- APA Group – The hunter becomes the hunted (13/6), ADD
- Wesfarmers – Taking care of business (7/7), HOLD

**In this issue indicates published research available online.**

# Contents

# **Economics** – the outlook for consumption

Real consumption growth has been relatively stable since 2013 with a real annual increase between 2% and 3%. This growth in household consumption has been stable despite a slower pace of household disposable income.

The low growth of household disposable income results from the fall in Australia's terms of trade between 2012 and 2016. Export prices fell relative to import prices because of the decline in Australian export commodity prices. This decline in commodity prices was also seen to generate much lower growth in nominal GDP. The country was receiving less money because the dollar price of its exports was less. This meant that individuals were also receiving a lower dollar income. Employment demand slowed, unemployment rose and wages growth weakened.

Starting in 2016, Australian export prices began to recover. This in turn led to individuals receiving a higher dollar income. This dollar income was the result of rising demand for labour leading to more people in jobs. The increase in income occurred despite wage growth is low and flat.

Let us turn to the issue of consumption ratio. Even though disposable income was weak in real terms between 2012 and early 2016, consumption continued to grow at the same stable rate. What allowed this to happen was the decline in the savings rate. The savings ratio fell from 8% to 4% over that time. Households decided to save less of their income and spend more of their income. This meant that demand could increase because households were spending an increased proportion of their income.

Even though household disposable income was soft, house prices continued to rise, relative to disposable income from 2012 to 2017. This was partly allowed by interest rates which first fell from 4.25% to a record low 1.50% in 2017. The average house price rose 66% in Sydney and 53% in Melbourne over the six-year period.

As a result of these lower interest rates, households could accumulate more debt relative to income, which in turn supported growth in domestic demand.

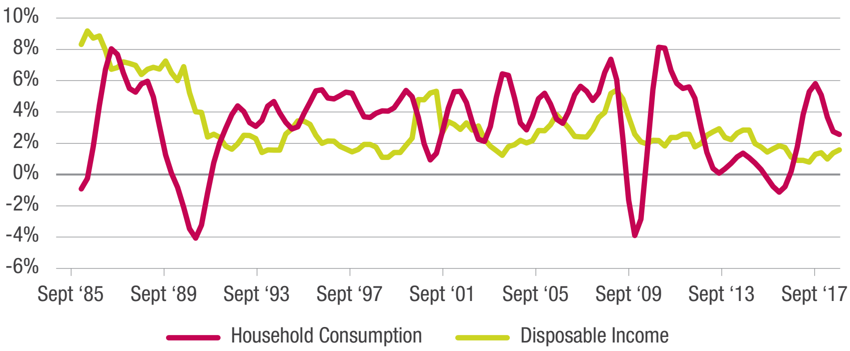
### The way forward

Australia is now beginning a modest recovery from the very soft growth in household incomes that occurred from 2012 to 2016. This recovery in household incomes is a result of improved commodity prices. These higher household incomes should support a steady path of consumption over the medium-term. While we don't expect a return to the golden period for consumption, we do think that rising household income will continue to support steady growth. Furthermore we don't expect a rise in the RBA's cash rate until at least the second-half of 2020, which should also provide support for growth over the medium-term

Australia is now beginning a modest recovery from the very soft growth in household incomes that occurred from 2012 to 2016.

For more refer to our Economics coverage piece **Is the US yield curve signalling a future recession?** smarturl.it/USYieldCurve

**Figure 1 – Household Income and Consumption**




Source: ABS

**Figure 2 – Australian Household Savings Ratio**


Source: ABS

# Banks

## Outlook for credit growth

**Concerns about a significant reduction in credit growth have increased over the course of the Royal Commission as the Royal Commission has scrutinised the serviceability assessments of the banks. There have been concerns that banks are now carrying out more rigorous income and expense assessments and that this will work against credit growth.**

However, we are not bearish on this front. RBA data shows that system housing credit growth over the last 12 months has been 6.0% and we expect system housing credit growth over the next 12 months to be 6.0%. Price competition for owner-occupier principal and interest home loans remains intense with hefty front book discounts on offer. This is supporting owner-occupier home loan growth. Owner-occupier growth over the last 12 months was 8.0%, up from 5.1% for the 12 months ended 30 April 2018. In contrast, over the same period of time investor home loan growth has declined from 10.8% to 2.3%. However, APRA is currently in the process of lifting the 10% investor home loan growth cap for individual banks and this may result in some improvement in investor home loan growth. Also, the banks have now all rebased their quarterly new interest-only home loan flows to less than 30% of total new residential lending, so we do not expect this factor to be a drag on investor home loan growth going forward.

While falling house price growth will work against credit growth through lower average loan size, it is possible for this drag on credit growth to be offset by increased first home buyer activity.

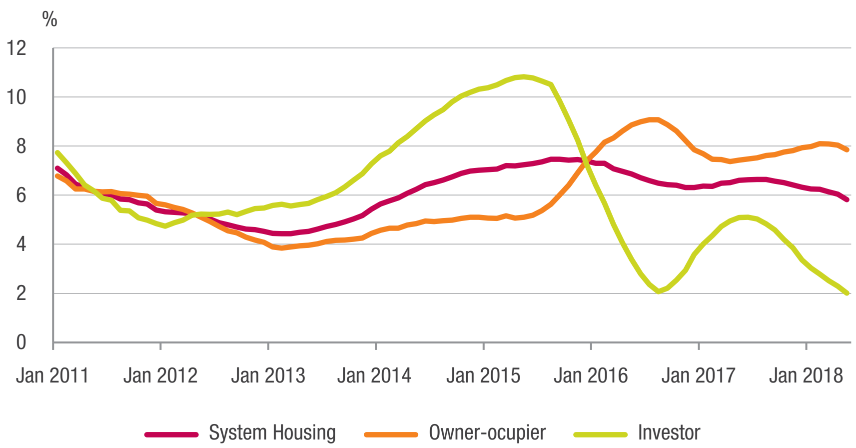
> We also are not bearish on credit growth as we do not expect the government and the RBA to sit on their hands if credit growth declines materially.

Also, we believe it is important to note that major cities on the east coast have experienced strong house price growth in recent years during a period when system housing credit growth has been close to historical lows. We therefore do not believe that strong house price growth was solely driven by credit growth. In fact, we are of the view that offshore money was a significant driver of the surge in house prices. We also believe that recent softening of house price growth in Sydney is partly attributable to reduced foreign money inflow into housing.

We also are not bearish on credit growth as we do not expect the government and the RBA to sit on their hands if credit growth declines materially, as we expect such a scenario to result in increased risk of recession on the east coast. We believe that if credit growth declines materially, then the RBA will cut the Official Cash Rate and/or the government will provide fiscal stimulus to housing.

While we are not bearish on credit growth, there are two scenarios that worry us most about housing and credit growth. The first is the scenario in which Chinese capital

**Housing Credit Growth**




Source: ABS

controls become very effective. Such a scenario would jeopardise foreign money inflow into Australian housing which in turn risks shattering the confidence of local housing investors. Such a scenario can result in material house price declines.

The second scenario which we find worrisome is a strong and sustained resources recovery. In this scenario, the government would be better positioned to address the housing affordability issue without creating a nationwide recession. That is, as the resources sector supports economic growth the government will be better positioned to address imbalances in the housing sector. An unintended consequence of this could be a material reduction in house prices.

From a bank's asset quality perspective we continue to be of the view that housing exposures are more defensive than institutional and business lending exposures for the following reasons:

1. Generally when the credit environment deteriorates, institutional exposures are first to be affected (particularly as they are relatively unsecured exposures), followed by business lending exposures, and housing exposures are generally last to be affected;
2. The majority of the major banks' home lending in Australia is full-recourse lending, meaning that borrowers have no incentive to default;
3. Standard home loans written with an LVR>80% are generally covered by lenders' mortgage insurance (LMI). Low-doc loans written with an LVR>60% are generally covered by LMI.
4. The major banks generally tightened serviceability assessments significantly in 2015.

As a result of the points mentioned above, we believe Westpac has a defensively positioned loan book with its loan book relatively skewed to Australian home lending. This is one of the reasons why Westpac is our preferred major bank. We view Westpac as having the overall lowest risk profile of the major banks for the following reasons:

- Defensively positioned loan book;
- Relatively low reliance on treasury and markets income, which we view as a low-quality income stream; and
- Good management team

We believe **Westpac** offers the most compelling value of the major banks at current share prices.

For more detail, refer to our recent **Westpac Update** smarturl.it/WBC-update

### Preferred Major Bank Exposures

| Ranking | Stock | Recommendation | Share Price | Target Price | Previous Target Price | Dividend Yield | Gross Yield | 12m Forecast TSR |
|---|---|---|---|---|---|---|---|---|
| 1 | WBC | ADD | $29.25 | $35.00 | $37.00 | 6.4% | 9.1% | 29% |
| 2 | NAB | ADD | $27.38 | $33.00 | $34.50 | 7.1% | 10.2% | 31% |
| 3 | CBA | ADD | $73.59 | $79.00 | $80.00 | 5.6% | 8.0% | 15% |
| 4 | ANZ | ADD | $28.10 | $29.00 | $30.00 | 5.7% | 8.1% | 11% |

Source: Morgans, IRESS. Data as at 4 July 2018.

# **Fixed interest** – preferred AT1 bank exposures

**There has been, and continues to be, significant focus on Australian financial institutions with the Royal Commission into the Banking, Superannuation and Financial Services Industry garnering media headlines.**

Since the first public hearings commenced in mid-March 2018 the share prices of the 'Big 4' banks have fallen on average by 5% while the prices of major bank issued Additional Tier 1 (AT1) securities have remained steady over the same period. We continue to believe that investors should utilise major bank AT1 instruments as part of a balanced fixed interest portfolio allocation given their attractive franked income and relative capital stability. The securities sit above bank equity in the capital structure and pay preferred income which has to be paid to investors before the bank can pay a dividend to ordinary shareholders. When taking a portfolio approach with these securities, our preference is to have a weighted term to call of approximately three years and our preferred major bank AT1 picks are outlined in the following table.

For more refer to our published report **Fixed Interest Weekly** smarturl.it/FixedInterestWeekly

**Preferred Major Bank AT1 Securities**

| ASX Code | Last Price | Rec. | Cash Running Yield | Gross Running Yield | Yield to Call | Trading Margin | Call / Maturity Date | Term to Call | Issue Size (m) | Dist. Rate |
|---|---|---|---|---|---|---|---|---|---|---|
| WBCPD | $100.80 | ADD | 3.64% | 5.20% | 4.66% | 2.71% | 8 Mar 19 | 0.7 years | $1,380 | 3.20% + 90d |
| NABPB | $100.49 | ADD | 3.69% | 5.28% | 5.46% | 3.26% | 17 Dec 20 | 2.5 years | $1,720 | 3.25% + 90d |
| ANZPE | $100.90 | ADD | 3.69% | 5.27% | 5.82% | 3.48% | 24 Mar 22 | 3.7 years | $1,160 | 3.25% + 180d |
| CBAPD | $96.40 | ADD | 3.51% | 5.01% | 6.23% | 3.80% | 15 Dec 22 | 4.5 years | $3,000 | 2.80% + 90d |
| ANZPG | $104.39 | ADD | 4.53% | 6.47% | 6.48% | 3.93% | 20 Mar 24 | 5.7 years | $1,622 | 4.70% + 90d |

Source: Morgans, IRESS. Data as at 5 July 2018.

# **Retail** – fading 'wealth effect'

**The Australian housing market is clearly softening. From here, the extent to which housing corrects further is debatable and largely dependent on our banks' lending practices and the RBA's response, amongst other factors.**

House prices have historically been the biggest driver of household goods sales, which is why the current dynamic is so important in terms of our view on consumer spending the outlook for listed retailers.

We think the following factors are key in driving household demand medium term: 1) reduced availability of credit for mortgages (particularly post the Royal Commission); 2) rising mortgage rates (investors and interest only borrowers); and 3) wage growth below mortgage rates and inflation (i.e mortgage pressure). This said, the all-important unemployment rate remains low with c3% job growth pa and the participation rate remains high.

We are certainly more cautious on the backdrop for consumer spending given the cooling housing market. The 'wealth effect' which has meaningfully propped up spending in recent years is fading, households that were more upbeat on the value of their home and therefore spent more are now more frugal.

The most leveraged categories to housing are furniture and appliances. In this context, we believe the retailers with the most exposure/risk are Harvey Norman, The Good Guys (owned by JB Hi-Fi), Nick Scali and Bunnings (owned by Wesfarmers). This said, the broader discretionary retail sector can also be impacted via a negative 'wealth effect'.

Against the above backdrop, we prefer niche players with more defensive business models, competitive advantages, low direct housing exposure and with growth options outside just pure consumption. Our preferred exposures: **Bapcor** (defensive auto), **Corporate Travel Management** (travel spending more resilient, especially in the corporate sector) and **Lovisa** (value pricing + material offshore rollout potential).

# High Conviction Stocks

We currently expect the S&P/ASX 200 index to finish the year around the current level but the outlook particularly this late in a sustained business cycle, is becoming more vulnerable. We prefer to stick by conviction calls. Opportunities are few and far between, but they do exist. We recently highlighted 11 opportunities for a directionless market, which detail compelling trading/accumulating ideas in oversold large and mid-cap stocks including Ramsay Health Care, Link Administration and Star Entertainment.

We added **Kina Securities** (KSL) to our High Conviction list this month following the recent ANZ acquisition in PNG. Kina offers a strong growth profile (42% FY18-20, 2-year CAGR) backed by 12% yield trading on 5.1x 2019 PE. We expect KSL to produce a record FY18 profit, yet it still trades at a ~22% discount to its IPO price.

We remove Cleanaway following strong share price performance and now trading near with our 12-month price target.

Refer to our latest High Conviction Stock list published 2 July 2018 **www.morgans.com.au/stockpicks**

| Morgans Research – Preferred Sector Exposures | |
|---|---|
| **Banks** | Westpac, BOQ |
| **Financials** | Suncorp, Kina Securities, CML Group |
| **Industrials** | Cleanaway, Wagners, Orora, PWR Holdings |
| **Healthcare** | Resmed |
| **Telecommunications** | Telstra, Superloop |
| **Resources** | Oil Search, BHP, Senex, Orocobre |
| **Consumer Discretionary** | Apollo Tourism, Bapcor, Motorcycle Holdings |
| **Food & Agriculture** | A2 Milk |
| **Infrastructure** | Transurban, Ausnet Services |
| **Online services** | Carsales, Catapult |

# Recent initiations

**Firstwave Cloud Technology**
ADD PT A$0.33

Cyber security is one of the biggest challenges facing businesses today. FCT takes enterprise-grade cyber security solutions and makes these available to SMBs.

**IDP Education**
HOLD PT A$10.70

IEL is the largest international provider of student placements into tertiary educational institutions and operates and co-owns the largest global English proficiency test, IELTS.

**Otto Energy**
ADD PT A$0.11

OEL is an oil and gas exploration and producer with a regional focus on North America. It offers a de-risked production profile with further upside from exploration.

**Zip Co (Z1P)**
ADD PT A$1.06

ZIP is an emerging player in the digital retail finance and payment industries in Australia. ZIP has delivered strong growth since listing in 2015.

**Acrow Formwork (ACF)**
ADD PT A$0.37

ACF services the Australian construction industry with the majority of earnings generated through the hiring of formwork, falsework and scaffolding equipment.

## Queensland

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