Investment Watch

August 2018

morgans

Welcome

Reporting season kicks off this month. Investors are waiting for a circuit-breaker to finally see the S&P/ASX 200 break out of its trading range. However, elevated valuations and mixed earnings momentum will likely keep the market rangebound in our view. This month, we explore the key themes to watch and dive into sectors (Resources, Retail) we think will provide some upside for tactical investors in August.

Recently published research

- Resources – Reporting Season Playbook (28/7)
- Corporate Travel Management – Runway cleared for future growth (26/7), ADD
- OZ Minerals – Carrapateena potential under-appreciated (25/7), ADD
- Retail – Retail Therapy, Reporting Season Preview (24/7)
- Orora – Keeping the momentum going (24/7), ADD

In this issue 🔗 indicates published research available online.

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Economics – is the US Yield Curve signalling a future recession?

Last October, we discussed a commentary by Patrick Harker, the President of the Philadelphia Federal Reserve, on the importance of the US Yield Curve, as an indicator of future US recessions.

Harker had said that the Federal Reserve (Fed) needed to keep an eye on the shape of the yield curve as the Fed tightened monetary policy. He suggested this might aid the Fed to tighten more slowly, so as not to provoke another US slowdown.

We examined the data for the period 1982 to 2017. We found that Harker was correct. Using a measure of the yield curve as US 10 year bond yields minus 90 day bill yields, we found that variation in the shape of the yield curve had a 100% success rate in predicting US recessions since the early 80's. We found that the yield curve did not have to fall below zero to forecast a recession.

It was sufficient for this measure to fall below 0.5%. This level was particularly relevant in the late 1980's and early 1990's. It was at this time that a modest slowdown in the US economy caused by a crisis in US 'savings and loans' (similar to Australian building societies), began a US slowdown which provoked the Australian recession of the early 1990's.

What was different over the time period was the lag between this inversion in the yield curve and when a US slowdown occurred. In the data before the year 2000, an inversion of the yield curve appeared to lead to a US slowdown after a period of around five quarters. After the year 2000, an inversion in the US yield curve appeared to lead to a US slowdown after a period of around nine quarters.

Is the next US recession in sight?

Right now, the Federal Reserve has been tightening for almost two years. How close are we to the yield curve telling us a recession awaits? In the figure below, we see the US yield curve for the period from 1982 to 2018. The US yield curve, which peaked at around 3.7% in April 2010, has been tightening progressively over the following period. This tightening began even before the Federal Reserve began to increase the Fed Funds rate.

Since 2016, the Fed rate hikes have been followed by an increase in 10 year bond yields. 10 year bond yields have been losing the race with the Fed Funds rate. This means that the yield curve has been tightening. On 27 July, our measure of the yield curve had fallen to 97 basis points. Still, 97 basis points is above our precautionary level of 50 basis points, which signals a future US recession.

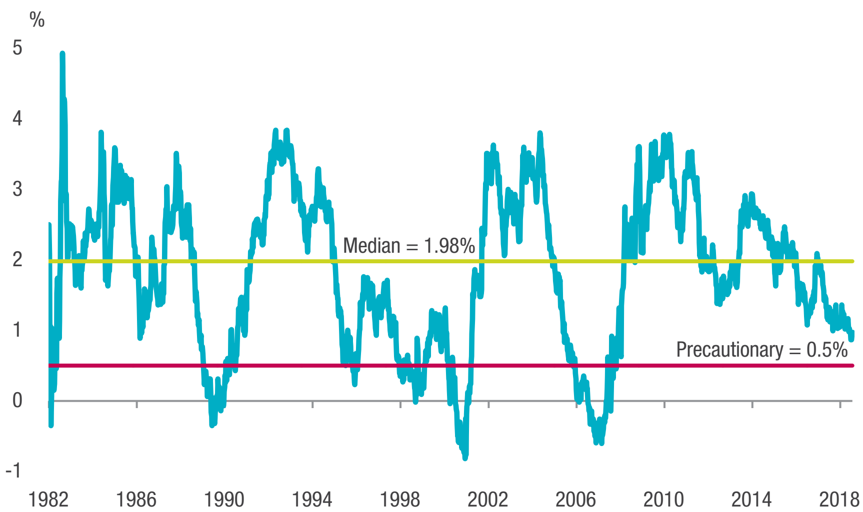
Should there be no further increase in 10 year bond yields, then by early next year further increases in the Fed Funds rate will bring the yield curve down below our precautionary level of 50 basis points.

The current shape of the US yield curve does not signal a coming US recession. Should the Fed continue to tighten at the current pace, this signal of a forthcoming US recession might be apparent by early next year.

We found that variation in the shape of the yield curve, had a 100% success rate in predicting US recessions since the early 80's.

For more Economics coverage, refer to the recent **Q3 Investment Strategy** bit.ly/Q3InvestmentStrategy

US Yield Curve (US 10Y Govt Bonds – 90 Day Bills)



Sources: Factset, Morgans

Equity strategy

Reporting season preview

Investors are waiting for a circuit-breaker. Stretched valuations limit upside potential for a further re-rating of the market multiple (15.8x 12m forward PE, Industrials ex-Financials at 21.8x) and without clear earnings momentum in either direction the market is likely to remain rangebound. In our view it is likely market rotation rather than breakout will define the FY18 reporting season.

We don't see sufficient domestic earnings momentum to deliver a broad upgrade cycle at this stage. Global factors (lower AUD, commodities prices, US led growth) are more likely to deliver upside surprise to forecasts in our view.

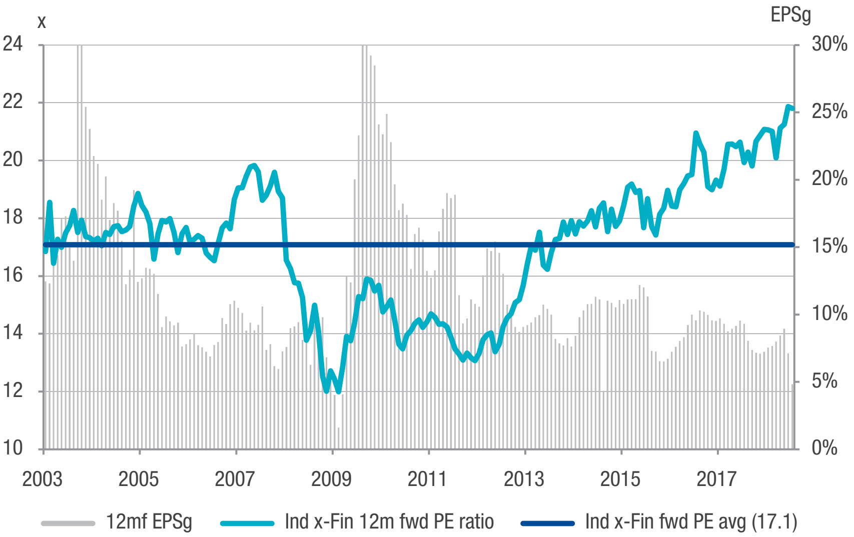
Despite rising costs in-synch with the cycle, the major miners offer clear dividend and capital management upside due to their ongoing divestment programs.

On track for a solid but unspectacular season

FY18 reporting season kicks off in earnest early August, and according to the latest Thomson Reuters earnings estimates, EPS for the S&P/ASX200 is forecast to grow 7.9% in FY18, down from 11.3% in FY17.

This pace of growth is forecast to continue in FY19 (+8.8%) providing a platform for steady equity returns assuming the market multiple holds, with steady global growth and improving business conditions offering some potential upside. In our view, the sectors best placed for upside surprise this reporting season include Resources, Offshore Earners and a subset of Retailers.

Industrial ex-financials valuations remain elevated



Sources: Thomson Reuters I/B/E/S

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 (CSL, DMP, BKL, BAL, CGC).

The market is at an important juncture. Until now, valuations of growth stocks have become very difficult to justify on fundamentals, but the alternative of buying value in often challenged industries is even harder to stack up. The likelihood of higher interest rates and vast valuation gap between the two segments means we are getting close to the inevitable rebalancing.

Earnings revisions sending mixed signals

Clear earnings momentum resides with beneficiaries of the falling Australian dollar which peaked at US 81c at the beginning of the February reporting season. Cyclicals are well represented in both the recent upgraders and downgraders as earnings momentum is both under and over-estimated by the market.

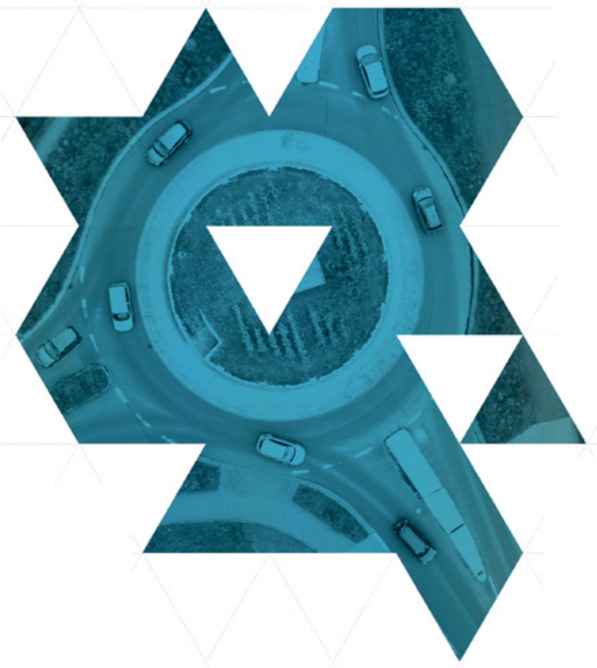
Otherwise earnings momentum has been mixed coming into August, positively led by Energy, Staples and Media but weighed down by negative momentum in Telcos, Consumer Services and Financials.

Dividends and franking in focus

February reporting season showed companies are still unwilling to dial back payout ratios or scale down buyback programs. Dividends were up for 69% of February reporting companies and some major buybacks were announced including QAN, LLC and RIO.

Dividends remain very much in focus for investors and a priority for corporates but often at the expense of growth capex. This adds to concerns about the degree to which many companies are under-investing to deliver cash to shareholders now at the expense of future growth.

If elected, the Labour Party is proposing to repeal a concession that allows excess dividend imputation credits to be refunded. We think this proposal might prompt companies with large franking accounts to accelerate capital management initiatives such as paying special dividends.



Tactical positioning into August

We think that avoiding the downside is as important as identifying the upside in the current market. In the table below Morgans' research analysts flag key candidates for potential upside and downside reactions to August results relating to reported earnings, outlook statements and vulnerable valuations.

Here's our key items to watch in August

- **Earnings momentum** – remains a reliable indicator of returns in the post-GFC low growth period. Expectations are increasingly more difficult to support without the commensurate earnings growth.
- **Evaluating the growth into value switch** – the threat of higher interest rates and vast valuation gap between the two segments of the market means we are getting close to the inevitable rebalancing.
- **Consensus earnings trends** – analyst forecasts tend to be very consistent suggesting a high degree of confidence in companies hitting guidance.
- **Signals from short interest** – while overall short sellers have been cutting exposure into August, some stocks remain highly shorted, especially in some high PE names.
- **Focus on dividends and franking** – as was the case last reporting season dividends remain very much in focus for investors and a priority for corporates but often at the expense of growth capex.
- **USD earners and offshore tailwinds** – Resurgent US growth following the fiscal boost through tax reform has lifted confidence and prospects for earnings in the US. We think these tailwinds will translate meaningfully for ASX US exposed cyclical names.
- **What to make of the current Resources cycle** – despite our expectations that cost inflation will again feature throughout reporting season, the major miners offer clear dividend and capital management upside due to their ongoing capital discipline and divestment programs.

Market rotation rather than breakout will define the FY18 reporting season.

For more refer to our published note **Reporting season preview** bit.ly/ReportingSeasonPreview

Reporting season potential hits and misses

Catalyst	Stocks
Earnings beat / Upgraded outlook	Suncorp, IAG, Adairs, Wagners, GWA, Acrow, Smiles Inclusive, Cleanaway and Kina Securities
Earnings miss / Softer outlook	Coca-Cola Amatil, Ramsay Health, Automotive Holdings, Michael Hill, Vocus, Costa Group, Nanosonics, Amcor, Monash IVF, Transurban
Overvalued / Vulnerable / Sell	Blackmores, Bellamy's, CSL, Domino's, Infigen, Aurizon

Source: Morgans

Retail – some retail cheer

We think a late surge in retail spending (June) will buoy 2H18/FY18 results, while Amazon is yet to have any discernible impact.

Key themes we're seeing

1. Strong online sales growth/penetration;
2. FY18 FX tailwinds moderating into FY19;
3. Strong growth in statement jewellery/sneaker/auto/homeware categories; and
4. A softening NSW but improving WA market.

The retail sector currently comprises a wide divergence in trading multiples, with rare growth stories commanding extreme premiums. Conversely, traditional bricks and mortar rollout retailers trade at a material discount.

We maintain a clear preference for the specialty retailers with dominant market positions, less Amazon exposure, solid earnings growth prospects (risk to the upside) and valuation support.

Our key picks:

- Adairs – trading on 10x FY19 PE with upside risk to consensus forecasts, in our view.
- Noni B – we see continued upside earnings risk, with cost-out likely to exceed targets in our view. Trading on 9.6x FY20F PE.
- Baby Bunting – at risk of another short term miss, but with the last major competitor close to shutting its doors, we think the stock is cum a large earnings catch up.
- Apollo Tourism – Solid earnings growth still achievable despite a very strong FY18. Trading on <10x FY19 PE with earnings risk to the upside.

We see FY18 reporting season/outlook risk in Automotive Holdings, Domino's and Michael Hill.

For more refer to our **Retail Reporting Season Preview – Retail Therapy** bit.ly/ReportingSeasonPreview

Recent initiations

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.
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.

Resources – making the most of the cycle

Despite our expectations that cost inflation will again feature throughout reporting season, the major miners offer clear dividend and capital management upside due to their ongoing capital discipline and divestment programs.

Cost inflation likely to again feature

February marked a notable turning point for industry costs as productivity gains become harder to achieve and as input cost pressures in labour and electricity began to be felt. Clearly the higher oil (diesel) price environment maintains this upward pressure, which we think will again be a feature across the sector. While a headwind, rising costs are consistent with improvement in the commodity cycle, synchronous with higher prices.

Replacement capex

The industry, by and large, is maintaining good supply side discipline but is increasingly looking toward stepping up investment into replacement capital, in part to fill a period of underinvestment in recent years. We don't think this will materially alter the cashflow available for capital returns of the majors, but it will likely be material to the outlook for industry service providers across engineering (MND, WOR), contracting (CIM, DOW) and niche providers (EHL, MRM).

Capital management focus

Several major divestments in coal (RIO's Hail Creek & Kestrel) and oil (BHP's US onshore) have been announced this half. The majors are already comfortably de-geared such that most, if not all, of these surplus sale proceeds are likely to make their way back into the hands of shareholders. We expect higher dividends and potential buybacks out of the majors in August.

For more refer to our published note **Reporting season preview** bit.ly/ResourcesPreview

High Conviction Stocks

The market continues to track sideways, with high valuations limiting a breakout to the upside. Investors have been in a holding pattern in the absence of clear earnings signals in either direction. Reporting season will provide the much needed signal for investors to gain confidence that the outlook painted by high consumer and business confidence is translating into a better outlook for earnings.

Irrespective of the prevailing market conditions, we add three High Conviction stocks to the list this month: **OZ Minerals**, **Atlas Arteria** and **Volpara**. We believe they offer investors a solid return for investors on a risk-adjusted basis over the next 12 months.

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

ASX 100	Ticker	Price	Price Target	FY19 Dividend Yield	FY19 Gross Yield	FY19 PE (x)	12m TSR
Suncorp	SUN	$14.83	$14.65	5.1%	7.3%	16	6%
Atlas Arteria*	ALX	$6.49	$6.85	6.1%	6.1%	14	12%
OZ Minerals*	OZL	$9.51	$10.75	1.5%	2.1%	15	15%
Westpac	WBC	$29.20	$35.00	6.5%	9.3%	11	29%
Ex-100	**Ticker**	**Price**	**Price Target**	**FY19 Dividend Yield**	**FY19 Gross Yield**	**FY19 PE (x)**	**12m TSR**
Volpara*	VHT	$0.79	$0.93	–	–	–	18%
PWR	PWH	$2.86	$3.40	2.8%	4.0%	21	23%
CML Group	CGR	$0.58	$0.69	4.2%	6.1%	12	24%
Kina Securities	KSL	$0.93	$1.34	13.1%	13.1%	6	58%

Source: FactSet, IRESS, Data as at 2 August 2018
* New Addition

Indicates published/linked Research Note

Technical corner

S&P/ASX 200 (XJO) – Losing momentum

- After breaking its key resistance of 6150 on June 20, 2018 the index traded higher and our upside price target of 6250 has now been reached.
- While at this point there is no sign the secondary up trend is reversing, we note that a bearish divergence has formed on the daily chart, which shows that the upswing from the April 2018 low is losing momentum.
- The weekly momentum indicators are approaching overbought territory suggesting that the market is likely to take a breather in the months ahead. Given the deterioration in the daily momentum conditions and the overbought momentum readings on the weekly chart, we are of the view that the market is likely to trade sideways in the months ahead.

XJO Price Chart

Source: IRESS

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