Investment Watch

October 2018

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Welcome

The world economy is still growing at around trend, which is a generally positive background for risk assets, but investment outcomes have become highly dependent on ongoing gains from U.S. equities. The most likely outlook in our view, is ongoing global expansion, though trade wars, monetary policy mistakes, wobbles in emerging markets, and geopolitical shocks are all real risks to monitor. We look at the very real risk of US interest rates above 4% and the outlook for the equity market this month.

Recently published research

- Westpac– Negativity still looking overdone (27/9), ADD
- REA Group – Sailing through the slump (24/9), ADD
- Rio Tinto – Plugs proceeds into new buyback (20/9), ADD
- Telstra – A net immaterial NBN tweak (16/9), ADD
- Transurban – Capital raising for successful WCX bid (5/9), ADD

In this issue indicates published research available online.

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Economics – why the benchmark US 10 year bond can rise to 4%

Last month I made a series of presentations in Sydney and Melbourne. As is my custom when I do these presentations, I try to say a few outrageous things.

What surprised me was that the forecast that I thought was most outrageous was the one that my fund manager audience thought was the most likely. This forecast was that US and Australian ten year bond yields would go to 4%.

The argument that bond yields, particularly US bond yields, will go to 4% is really easy to make.

In the figure below, we look at the US yield curve since January 1985. In the 30 plus years since that time, the US yield curve has varied in a wide arc, but over each business cycle, US 10 yield bond yields are an average of almost exactly 2.0% higher than 90 day US treasury yields.

Over this time, US 10 year bond yields have been an average 1.91% above US 90 day treasury bill yields. The median of this difference is 1.97%. Let's say 2.0% is pretty close.

The Fed tells us that right now on 4 October, US 90 day treasury bills are trading at 2.22%. The 'effective' Fed funds rate is 4 basis points lower at 2.18%. This means that if the US yield curve was right now at its average long term level, the 10 year bond yields would be the sum of 2.22% (90 day treasury bill yields) plus 1.91% (the average yield curve) leading to a total of 4.13%. This means that if the Fed funds rate were to stay exactly where it is now over the rest of the business cycle, then we would expect US 10 year bonds to rise to a yield of 4.13% by the end of the business cycle.

But wait there's more!

The Federal Reserve, in its Summary of Economic Projections released in September 2018, says that it expects that the Fed Funds rate for this business cycle to peak at 3.4% some time in 2020.

What would this mean for bond yields? Well we observe that right now US treasury yields are 4 basis points higher than the Fed Funds rate. By 2020 that would take US 90 day treasury yields to 3.4% plus 4 basis points or 3.44%. When we add the average long term yield curve of 1.91% to this, we get US ten yield bond yields at the end of the business cycle of 5.35%.

This means we can expect that if the Fed keeps tightening the way they think they will, then by the end of this business cycle the US ten year bond yield should rise to 5.35%.

The implications of this are dramatic. As of 4 October the US ten year bond yield was trading at 3.18%. By our calculations, this bond yield will rise by the end of this business cycle to 5.35%. We would expect Australian 10 year bond yields to rise by a similar amount.

Should this occur, the effect of such a rise in bond yields would have a more than significant effect on interest bearing securities and also on equity markets.

Conclusion

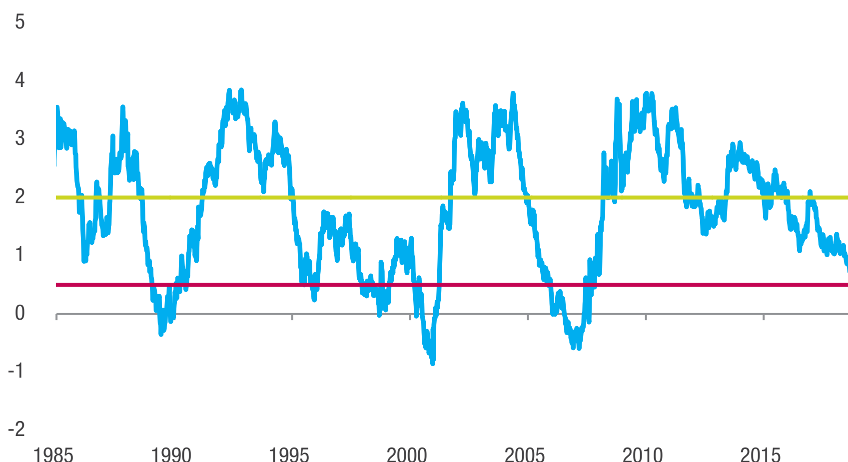
Over recent quarters, the gradual tightening of the Federal Reserve has had no real effect on financial markets. This is because 10 year bond yields have not risen in line with the increase in the Fed funds rate.

By the end of this business cycle, US 10 year bond yields should rise to some 2.0% higher than the Fed Funds rate. A glance at the Federal Reserve estimate of the Fund Funds rate of 3.4% in 2020 tells us that US 10 year bond yields could move higher than the market expects.

US 10 year bond yields have not risen to reflect increases in the Fed Funds rate. By the end of this business cycle, we believe they will.

Refer to our recent research for more Economics coverage
Trump vs China
bit.ly/TrumpVsChina-MichaelKnox

US Yield Curve (10-year bond yield – 90 day bill yield)



Source: Factset

Equity strategy

Protecting capital in an abnormal market

In spite of the somewhat cautious sentiment and negative headlines, the ASX 200 returned a respectable 15.4% (including dividends) at the close of reporting season in August, and is poised to return a similar amount over the next 12 months if all goes to plan. Factset consensus forecasts currently expect another year of 7.2% earnings growth at a dividend yield of 4.6% which puts the ASX 200 on course for another year of double digit returns assuming current market valuations hold.

Where we are cautious is the price investors are paying for stocks in certain segments of the market, which remain elevated. This can indicate heightened expectations for future earnings growth or that investors are willing to pay more for less. We think it's a combination of the two where expectations continue to improve as underlying fundamentals remain sound and lack of alternatives (i.e. low interest rates) have pushed investors up the risk curve. We think this is a key area to watch and stocks falling short of expectations will be treated harshly by the market.

The world economy continues to perform well. Economic trends suggest that growth this year will match that of last year. In developed markets, strong labour markets are slowly lifting wages. Income growth is being spent. In the US and the UK, retail sales volumes are growing faster than last year. In Europe, volume growth rates are generally slightly slower, but still good. This is a generally positive background for risk assets, but investment outcomes have become highly dependent on ongoing gains from U.S. equities. The most likely outlook in our view, is ongoing global expansion, though trade wars, monetary policy mistakes, wobbles in emerging markets, and geopolitical shocks are all real risks to monitor

Bond yields in the U.S. have headed higher and have contributed to weak performance by global fixed interest and by global income-oriented assets like property and infrastructure. In the Australian economy, it looks as if the pace of business activity may be moving into a slightly higher gear, although the ongoing drag from the Financial Services Royal Commission remains a concern for the financials sector's equity performance.

There was also a pleasant surprise when the June quarter GDP data were released. The economy grew at a faster than expected, 3.4% in the year to June, well above

Morgans Research trim/sell/switch candidates

Recommendations	Stocks
Vulnerable to disappointment: Sell	Vocus, SpeedCast, Michael Hill, Monash IVF, Bega Cheese
Expensive: Trim or Switch	CSL, Cochlear, ASX, Domain, Blackmores, Freedom Foods, Accent Group, Domino's Pizza
Prefer others in the sector: Switch	ANZ, Pendal Group, IAG, Coca-Cola Amatil, Brambles, Aurizon, Automotive Holdings, Pact Group, Santos, Newcrest, South32, New Hope, Elders, Ansell

Source: Morgans

the 2.9% that forecasters had been predicting, and the news extended the already record-breaking economic expansion to a full 27 years.

One quarter's data might not represent a change in the trend. But it was an encouraging signal, and more recent data have generally confirmed that business activity is going well. The latest (September) business survey from National Australia Bank, for example, found that 'Business conditions regained some of the ground lost in recent months and have been well above average for some time. In addition, the forward orders index saw a rebound as did capital expenditure. Capacity utilisation remains high and the profitability index remains well above average.'

Despite the optimism in corporate Australia, equity market valuations remain stretched and measures of market volatility remain close to their all-time lows. We continue to caution investors against complacency and note that avoiding loss is just as important as achieving profits in the current market. We recently nominated 28 stocks in our **Reporting Season Review** that we believe offer compelling upside post-results. We flag stocks that are either 1) vulnerable to ongoing disappointment (sells); 2) worthy of trimming/switching on valuation grounds (trims/switches), or; 3) worthy of switching into more preferred names in their sector (switches).

For more refer to our published note
Sell, Trim and Switch Ideas
smarturl.it/ReportingSeason18

The ASX 200 on course for another year of double digit returns assuming current market valuations hold.

Key Macro themes to watch

		Key data points
Central Bank Policy	Central bank policy (Fed and ECB) has shifted from accommodation to normalisation, thus removing strong source of liquidity for assets. They are winding back in response to the strengthening economic environment but any unanticipated tightening of policy will have unintended consequences.	**US Federal Reserve:** FOMC interest rate projections. European Central Bank: Expectations of first rate hike. **Bank of Japan:** Commentary on altering the current stance on policy support.
Crowded Positions	Trades predicated on high growth, low volatility and low inflation have driven valuations to elevated levels. The return of volatility and higher interest rates will challenge returns in popular trades.	**Retail fund flow:** Strong retail investor sentiment has seen funds flow back into crowded trades (Tech and Healthcare). **Corporate credit spreads**: Signs of stress in the corporate credit can quickly reverse market sentiment.
Inflation	Inflation's impact on bond yields (term-premium) and stock prices can be very significant. The low inflation environment continues to puzzle central banks. The key risk to markets is not if but for how long inflation can remain subdued as the global recovery heats up.	**Wages growth:** An unexpected strong read in February triggered a market correction. **Input costs:** Cost pressures and falling margins featured across reporting season.
Trade Policy	Increasing protectionist sentiment has the potential to disrupt the global growth story. The US has launched some stiff tariffs on imported goods aimed primarily at curbing China's impact on its domestic manufacturing industry. The potential for this to spill into a global trade war cannot be ruled out.	**China Market Reforms:** Willingness of the politburo to negotiate and using stimulus against a deleveraging campaign will be key to avoiding a fallout from trade tensions.
Emerging market fragility	A stronger US dollar and rising interest rates have wreaked havoc in emerging markets, which has seen Turkish Lira down 40% YTD and Argentinian Peso down 54% forcing central banks to take unprecedented steps to sure up the economy.	**Brazil:** Major election in October. **China:** Infrastructure stimulus and impact of the recent trade tariffs.

Retail – a resilient consumer

The consumer continues to be relatively resilient, as evidenced by the solid recent reporting season results from the sector. However, signs of a cooling housing market (particularly in NSW and VIC) make us more cautious on the outlook for consumer spending, given the 'wealth effect' that has bolstered consumer spending in recent years. Next year's election is also front of mind as this usually has a dampening effect on retail trading for a short period.

We continue to watch Amazon as it ramps up its Australian presence. Amazon continues to grow its product range as well as recently launching Amazon Prime and its local Fulfilment by Amazon for Marketplace traders - although we note Amazon is still heavily reliant on local third party retailers. While this is unlikely to materially impact Australian retailers in the short-term, we would point to the impact Amazon continues to have on its US retailers 10 years on.

The consumer continues to adapt to the new norm and, as always, there are select opportunities for companies that have a compelling offering/competitive edge over their peers. We maintain a 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 include: **Adairs**, **Baby Bunting** and **Noni B**.

Adairs
ADD PT A$2.68
Daring to give guidance and accelerate the div

Baby Bunting
ADD PT A$2.65
Baby got back

Noni B
ADD PT A$3.94
The turnaround specialists

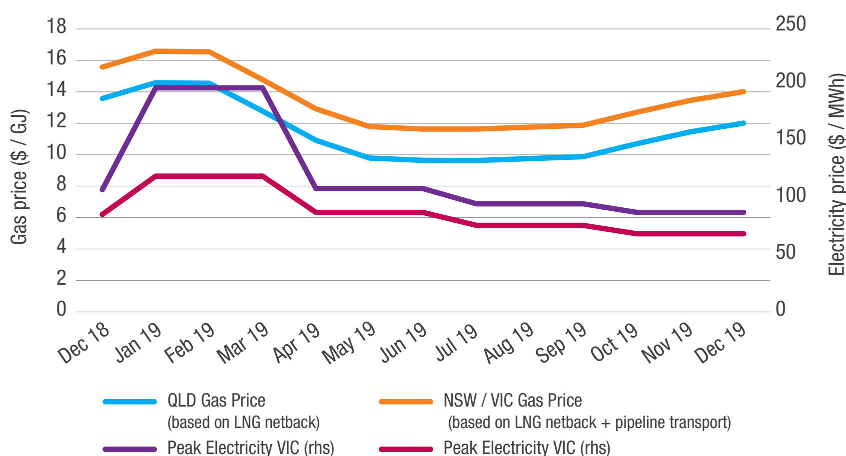
Utilities – regulatory uncertainty clouding outlook

Uncertainty in the electricity market given our recent political upheavals looks set to continue in the short term. The sitting government has backed away from the National Energy Guarantee and its ambitious goal of killing two birds with one stone: guaranteeing both greener and reliable energy at a reasonable price.

The energy minister, Angus Taylor, is only focused on reducing price but the policy mechanisms to achieve this are not yet clear. The sector is also facing calls for a royal commission similar to the banking enquiry and the Victorian government has fired a shot across the bow of AGL with a $3m fine and threatened to pull their retailing licence. The domestic gas market also faces regulatory uncertainty with more talk of the federal government activating the Domestic Gas Security Mechanism in the face of increasing oil linked prices available in the LNG market.

Despite the uncertainty and the ill will towards them the big integrated energy generators and retailers (AGL, ORG) are unlikely to lose their dominant market share. We are still too dependent on their base load generation to see any rival knock them off their perch. For this reason, we would suggest it may not be sensible to rush for the exits just yet even though their upside potential looks a little bit thin. Of the two companies ORG has the most likely upside potential with their part ownership in the oil exposed APLNG project. Investors may have better opportunities elsewhere though if they want exposure to a potentially rising oil price given the drag of their electricity business.

Domestic Energy Price Outlook



Source: Morgans Forecasts

Recent initiations

AGL
HOLD PT A$19.78

AGL Energy Limited (AGL) is an integrated energy company and owner, operator and developer of renewable energy generation in Australia.

Genex
ADD PT A$0.36

GNX is a renewable and energy storage company and developer of the Kidston solar and pumped hydro projects.

Zip Co (Z1P)
ADD PT A$1.11

Z1P is an emerging player in the digital retail finance and payment industries in Australia. Z1P has delivered strong growth since listing in 2015.

High Conviction Stocks

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

We added **Reliance Worldwide** to the list this month and removed Atlas Arteria.

Recent share price weakness was on the back of softer than expected FY19 guidance. RWC gave EBITDA guidance of $280-$290m vs consensus of c$300m. This has since reset market expectations and now has the stock trading at 24x FY19F PE in line with the broader Industrials despite a solid c26% three-year EPS CAGR. We also think the recently upgraded synergy targets ($30m over three years) will prove to be conservative, which should provide further earnings upside. We think RWC ticks many boxes with its stable earnings growth profile focused on the less cyclical residential R&R sector and with its globally diversified operations in North America, Asia-Pacific and Europe.

ASX 100	Ticker	Price	Price Target	FY19 Dividend Yield	FY19 Gross Yield	FY19 PE (x)	12m TSR
OZ Minerals	OZL	$9.50	$10.63	1.5%	2.1%	16	14%
Reliance Worldwide	RWC	$5.17	$6.25	2.1%	3.0%	24	24%
Westpac	WBC	$27.15	$34.50	7.0%	10.1%	11	37%
Ex-100	**Ticker**	**Price**	**Price Target**	**FY19 Dividend Yield**	**FY19 Gross Yield**	**FY19 PE (x)**	**12m TSR**
Volpara	VHT	$0.92	$0.93	_	_	_	1%
PWR	PWH	$3.25	$3.60	2.6%	3.8%	23	15%
Noni B	NBL	$3.55	$3.94	3.7%	5.2%	57	16%
Kina Securities	KSL	$1.12	$1.30	10.1%	10.1%	8	26%
CML Group	CGR	$0.54	$0.71	3.7%	5.3%	11	37%
Australian Finance Group	AFG	$1.55	$2.00	7.4%	10.6%	10	40%

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

Indicates published/linked Research Note

Technical corner

Reliance Worldwide (RWC)

- RWC has been trading in a strong up trend since February 2017 which is still firmly intact.
- The current pull back is clearly losing momentum and the price appears to have been in the process of building a small base.
- The RSI indicator is approaching oversold territory suggesting that the price is likely to bounce soon. The initial upside price target is $5.70. Over the medium term, levels to $5.92 are achievable. Given the proximity to support of $5.03 and the oversold momentum levels, we are comfortable to start accumulating the stock around current price levels.

Reliance Worldwide Price Chart

Source: IRESS

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