Investment Watch

February 2019

morgans

Welcome

A rather choppy end to 2018 saw the S&P/ASX 200 index down 9% over the final quarter. Tactically it has been a blessing in disguise for investors at the start of the year. Valuations have de-rated sharply on the back of a multitude of macro-economic scares and political uncertainty. This month we consider implications of Labor led government and what this could mean for the economy, equity market and house prices. The telecommunications sector has been in the doldrums for some time, this year is looking much brighter for returns and we explain why.

Recently published research

- Retail Sector – Stocktake – 1H19 reporting season preview (31/1)
- BHP – Big 2H expected (23/1)
- Sydney Airport – Key information coming in February (21/1)
- Afterpay Touch – Another solid update (18/1)
- Woodside Petroleum – Solid end to the year (18/1)

In this issue indicates published research available online.

Contents

Stay in touch

For breaking news, share prices, company research updates, analyst blogs, videos, podcast interviews, market updates and investment opportunities visit:

morgans.com.au or morgans.com.au/blog

youtube.com/c/MorgansFinancialLimited

@morgansAU

linkedin.com/company/morgans-financial-limited

soundcloud.com/morgans-financial-limited

Economics – Jay Powell's problem

I attended a presentation by the Chair of the Federal Reserve Jay Powell in Atlanta in early January 2019. This was part of the annual meeting of the American Economics' Association. This year that meeting was held in Atlanta. The presentation took the form of an interview conducted by the Economic Correspondent of the New York Times, Neil Irwin. The interview was with the current Chair of the Federal Reserve and the two previous Chairs, Janet Yellen and Ben Bernanke.

The lead up to this presentation was more than interesting. The stockmarket had fallen heavily between mid-September and the end of December. In the December meeting of the Fed, the Fed had downgraded its estimate of growth in 2019 from 2.5% to 2.3%.

In previous weeks, a widely read article in the Wall Street Journal by former Fed Reserve member, Kevin Warsh, had argued that the Fed was tightening too severely by increasing interest rates at the same time as selling down the holdings of bonds to reduce the size of the Federal Reserve balance sheet.

Jay Powell opened with a commentary about current conditions in the US economy. Reading from his prepared notes, he said that the current conditions reminded him of 2016 when he first came to the Federal Reserve Board. At that time, Janet Yellen was Chair. He said that uncertainty at that time led the Fed to pause its increases in interest rates.

The Fed did not just pause interest rates for a quarter. The Fed paused interest rates for a whole year. I was amazed to see monetary policy being made right in front of me. I imagined the very positive effect his statements would have on the market. And I was right. The Dow was up 600 points within two hours of my leaving the room.

One matter of concern was the reduction in the ability of the Federal Reserve to deal with future financial crisis. Powell, Yellen and Bernanke all expressed concern that many of the facilities which were used to support major financial corporations in the financial crisis have now been taken away from the Federal Reserve.

Congress undertook this action to remove what it regarded as moral hazard. The political view that if these facilities were not available, then banks would not get themselves into so much trouble. The problem is that most financial crisis happen for completely unexpected reasons. When the next one happens in the US, the Federal Reserve will be much less able to deal with the crisis than it was on the previous occasion.

Conclusion

As I watched Jay Powell through his presentation, I was impressed how concerned he was to avoid the next US recession.

His reference to 2016 was interesting. At that time the economy was growing reasonably well. There was however, a significant deterioration in the market for corporate debt. At that time and again now, investment growth corporate bond yields were rising relative to treasury yields. This signalled a reduction in liquidity necessary for corporate investment. This caused the US economy to slow.

A lot of work has been done on the relationship between corporate spreads and US growth, especially by the New York Fed.

Jay Powell's problem is that he wants to avoid the next US recession. He wants the US economy to slow to the level of around 1.8% to stabilise unemployment and inflation but avoid a major economic slowdown.

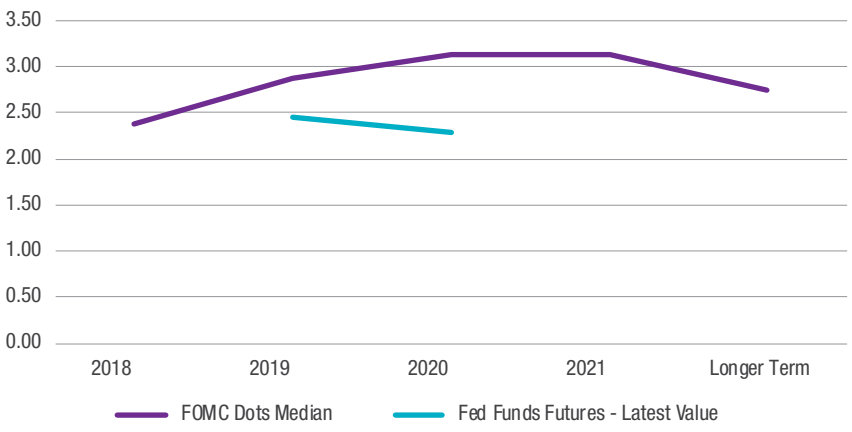
We think that Powell will pause interest rates through to the end of 2019 unless he gets significant evidence that there will be no recession later this cycle.

.

We think that Powell will pause interest rates through to the end of 2019.

Refer to our recent research for more Economics coverage **What the Fed changes and what the Fed doesn't**

FOMC Dot Plot – Fed Funds Rate Forecasts



Source: Bloomberg

Equity strategy

Implications of a potential change in government

These changes would therefore impede both employment and income growth. The question is, why do it?

For more coverage refer to our recent note published 18 January 2018.

Impact on the Australian economy

Labor intends to enter government with key policies that would incrementally increase taxes on investment in; 1) residential property; 2) public companies; and 3) on longer durations.

Changes to negative gearing would increase taxes on residential property investment. In the first phase, dwelling prices would fall, but rents would not. In the second phase reduced construction would reduce supply, putting upward pressure on rents. This may adjust the burden of housing affordability down from those who are trying to buy a dwelling to those (usually less fortunate) who are trying to rent.

Changes to dividend imputation would increase the tax on investment in public companies. A reduction in after-tax dividends relative to bond yields would notionally reduce the relative appeal of equities. This would incrementally increase the cost of equity capital and reduce the ability of listed companies to raise capital to invest.

Halving the CGT discount to 25% would notionally lower the incentive for entities to invest for the long periods of time necessary to develop businesses and build infrastructure.

The absolute impacts of these changes are difficult to quantify. However we note that investment is the strongest source of growth in any economy as private sector investment generates employment and higher incomes. These changes would therefore impede both employment and income growth. The question is, why do it?

Labor's motive appears simply to offset planned increases in government spending so as to contain the budget deficit and national debt. The problem is this strategy neglects behavioural effects. Western economies have learned the hard way that the public sector is less productive than the private, which comes down to a difference in incentives. Public sector employees are incentivised to be risk averse, while the private sector is incentivised to take risks and be rewarded by higher income. It is this acceptance of risk that generates higher investment and an expansion of growth and employment.

Impact on the housing market and banks

One of the reasons provided by Labor when it revealed its changes to negative gearing in 2016 was to level the playing field between first home buyers and investors. We think that APRA's macro-prudential policies, particularly the 30% cap on interest-only home lending, have already achieved this to a notable extent per the following observations:

1. home loan growth for owner-occupiers is now far exceeding that for investors;
2. first home buyer participation has been increasing; and
3. the Sydney and Melbourne property markets have softened.

Restricting negative gearing to new housing stock while the property market is soft is likely to exacerbate downward pressure on house prices and place stress on household balance sheets. We believe this may also put further pressure on the economy.

We think proposed negative gearing changes will prove unpopular with home owners across the board and wouldn't be surprised if Labor dropped the proposed policy.

Potential capital management opportunities

Tactical investors may benefit from an environment where corporates with large franking balances could bring forward plans to buy back shares and pay special dividends ahead of potential changes to franking. While long-term dividend policy is unlikely to change, 2019 may prove to be a bumper year for low-tax dividend investors.

To date, significant capital management initiatives such as buybacks and special dividends have been launched by the major resource companies which were strongly rewarded in jittery markets (BHP – US$5.2m buyback and US$5.2m special dividend, RIO – US$3.2m buyback).

We see the potential for further capital management initiatives from Woolworths, Wesfarmers, JB Hi-Fi, and Flight Centre as well the possibility of more returns from BHP and RIO over time.

Summary of possible implications of Labor policies if enacted

Segment	Policy change	Potential implications	Potential winners	Potential losers
Australian economy – overall	Higher taxes on investment (property, CGT and dividends)	Potential incremental impediment to investment, growth and incomes. Potential lift in political risk perceptions by offshore investors	ASX offshore earners	ASX-listed domestic cyclicals
Australian housing	Negative gearing	Downward pressure on house prices/ construction and additional stress on households and consumers although we're skeptical this policy will be retained.	ASX offshore earners	Housing/Developers, Building Materials, Retailers, Consumer Services
Banks & high yielders	Dividend imputation	Potential for a slight re-balance in the relative appeal of high yielders, but ultimately we think that larger economic forces will far outweigh the impact of this policy on this segment.	WOW, WES, FLT	NA
Energy policy	Default pricing and revival of the National Energy Guarantee + larger renewables target	Likely ongoing government/ regulatory pressure on electricity retailing. Possible stimulation of new renewables investment, lowering medium-term wholesale power costs.	Renewables focussed Contractors / Engineers	AGL, Origin
Healthcare	Ongoing policy focus / regulatory risk	Government spend may come under pressure in a low growth environment. Labor typically don't encourage greater participation in private health insurance/hospitals	Offshore healthcare (CSL, COH, RMD, ANN, NAN)	Healthscope, Ramsay, Sonic
Health insurers	Capped premium growth for 2 years from 2020	Exacerbation of existing margin risks for health insurers	NA	Medibank, NIB
Aged care	Reform post Royal Commission	Likely implementation of (stricter) RC recommendations	NA	Japara, Regis, Estia
Telco	Potential NBN write-down	A lowering of last mile access costs and an improvement in the NBN's competitiveness should see a return to more rational industry pricing.	Telstra, Over the Wire (preferred picks)	NA

Telecommunications – politics and practicality

It seems increasingly likely to us the telco sector will turn around in 2019 due to political drivers (NBN changes) and for fundamental reasons (less competition).

Labor are considering writing down the NBN if elected next year. This seems increasingly likely and would be positive for telcos. A lowering of the NBN asset value and last mile access costs seems inevitable and could open the door to resolving the NBN's challenges. In our view the most practical way to reduce NBN Co's operating costs by one-third is to remove the A$1bn per annum they pay to Telstra into perpetuity to put the NBN's cables in TLS's ducts. We see the potential to remove this liability by swapping it for NBN Co equity in a demerged and jointly owned NBN Infra Co.

Regardless, we're nearly through the thick of it with respect to NBN migration and competition. Today nearly 65% of Australian households (4.6m) are on the NBN and by December 2019 this will exceed 80%. With two-thirds of the market having switched to NBN, competition will dwindle.

The merger of TPG and Vodafone should proceed in 2019 and should reduce mobile competition. We think this the likely scenario now that TPG has announced it will cease the rollout of its Australian mobile network. In 2019 the first glimmers of 5G will also emerge. This will more clearly segment the market and this ability to differentiate should also reset the competitive intensity.

The sector looks likely to be a good place to park capital given the potential for a sector turnaround and as we potentially near the end of a ~10-year bull market, noting that the defensive nature of the sector typically outperforms in softer markets. Our key picks are **Telstra** and **Over the Wire.**

For more detail refer to recent Telecommunications sector note **Fixed & mobile market share and price check** 11 December 2018.

Banks – fears look overdone

Following the release of the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, we continue to believe the extent of regulatory risk baked into major bank share prices is overdone.

We do not expect new potential regulation will be as onerous as the bears expect, and we do not expect the magnitude of potential customer redress to hamper the ability of the major banks to meet APRA's 'unquestionably strong' capital requirements in an orderly manner by January 2020. Consequently, our base case for all four major banks is one of no cuts to nominal ordinary dividends per share over our forecast period. WBC remains our preferred major bank.

We do not anticipate further tightening in lending standards. In fact, we expect an easing in lending standards particularly as both sides of politics appear intent on ensuring the free flow of credit. We also imagine the RBA would prefer to see credit flowing more freely than it is currently.

We are continuing to go through cases which have been referred by Hayne to regulators for potential breaches of the law and what this means in terms of potential penalties for the institutions involved.

Preliminary view in more detail:

- **SME lending:** as we expected, **there are no significant changes on this front in our view.** It has been recommended by Hayne that the NCCP Act should not be amended to extend its operation to lending to small businesses.
- On **vertical integration**, our read at this stage is that it has not been recommended that wealth management businesses be separated from banking businesses. This is a positive for Westpac which continues to retain a substantial wealth management business.
- **Financial advice:** at first glance, it appears that most of the recommendations on this front have generally already been addressed by the major banks.
- **Insurance:** at first glance, we do not find any of the recommendations on this front to be overly concerning. It should also be noted that NAB, ANZ and CBA have or are in the process of divesting their life insurance businesses.

Recent initiations

Bingo Industries (BIN)
ADD TP A$2.37

Bingo Industries (BIN) makes money by providing waste collection and processing services with a focus on recycling.

Treasury Wine Estates (TWE)
ADD TP A$17.20

TWE is one of the world's largest wine companies. It has world class viticulture assets and a substantial brand portfolio that includes the iconic Penfolds brand.

High Conviction Stocks

Refer to our High Conviction update for more **www.morgans.com.au/stockpicks**

Investors continue to favour Growth over Value even as economic growth softens. Erratic growth rates and increasing sector specific risks mean a broad based approach will, in our view, lead to sub-optimal returns in 2019.

Our High Conviction stocks are those that we think offer the highest risk-adjusted returns over a 12-month timeframe, supported by a higher-than-average level of confidence. They are typically our preferred sector exposures. This month we add Oil Search to the ASX 100 list and Senex to the ex-100 list.

ASX 100		Ticker	Price	Price Target	FY19 Dividend Yield	FY19 Gross Yield	FY19 PE (x)	12m TSR
OZ Minerals		OZL	$9.87	$10.75	1.4%	2.0%	17%	11%
Cleanaway		CWY	$1.78	$1.94	2.0%	2.8%	28%	12%
Reliance Worldwide		RWC	$4.68	$5.57	2.3%	3.3%	23%	22%
ResMed		RMD	$13.14	$16.31	1.6%	2.3%	25%	26%
OilSearch		OSH	$7.84	$10.32	2.3%	2.3%	19%	34%
Westpac		WBC	$26.84	$34.50	7.6%	10.8%	10%	39%
Ex-100		**Ticker**	**Price**	**Price Target**	**FY19 Dividend Yield**	**FY19 Gross Yield**	**FY19 PE (x)**	**12m TSR**
Lovisa		LOV	$6.57	$7.94	4.2%	6.0%	19%	27%
PWR		PWH	$3.41	$4.25	2.6%	3.7%	23%	28%
Kina Securities		KSL	$1.01	$1.30	11.2%	11.2%	7%	40%
Volpara		VHT	$1.08	$1.55	–	–	na	44%
Senex		SXY	$0.34	$0.53	–	–	13%	56%
Australian Finance Group		AFG	$0.90	$2.00	9.0%	12.9%	8%	135%

Source: FactSet, IRESS, Data as at 5 February 2019

Indicates published/linked Research Note

Technical corner - Resmed Inc (RMD)

In our last update on January 6, 2019 we discussed that resistance around $16.00 is strong and highlighted that a break below $15.00 is likely, which in turn will trigger a decline to $14.00. After reporting top line revenue below market expectations on January 25, 2019, the price gapped down and our price target of $14.00 has been exceeded. Over the past period the selling pressure appears to be easing and $12.65 is holding support. The momentum indicators have reached oversold territory suggesting that the price is likely to rise in the months ahead. The potential upside price target is $14.50.

Price Chart

Source: IRESS

Queensland

Brisbane Stockbroking, Corporate Advice, Wealth Management	+61 7 3334 4888
Brisbane Edward Street	+61 7 3121 5677
Brisbane Tynan Partners	+61 7 3152 0600
Brisbane North Quay	+61 7 3245 5466
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
Holland Park	+61 7 3151 8300
Ipswich/Springfield	+61 7 3202 3995
Kedron	+61 7 3350 9000
Mackay	+61 7 4957 3033
Milton	+61 7 3114 8600
Noosa	+61 7 5449 9511
Redcliffe	+61 7 3897 3999
Rockhampton	+61 7 4922 5855
Spring Hill	+61 7 3833 9333
Sunshine Coast	+61 7 5479 2757
Toowoomba	+61 7 4639 1277
Townsville	+61 7 4725 5787

New South Wales

Sydney Stockbroking, Corporate Advice, Wealth Management	+61 2 9043 7900
Sydney Grosvenor Place	+61 2 8215 5000
Sydney Reynolds Securities	+61 2 9373 4452
Sydney Currency House	+61 2 8216 5111
Armidale	+61 2 6770 3300
Ballina	+61 2 6686 4144
Balmain	+61 2 8755 3333
Bowral	+61 2 4851 5555
Chatswood	+61 2 8116 1700
Coffs Harbour	+61 2 6651 5700
Gosford	+61 2 4325 0884
Hurstville	+61 2 8215 5079
Merimbula	+61 2 6495 2869
Mona Vale	+61 2 9998 4200
Neutral Bay	+61 2 8969 7500
Newcastle	+61 2 4926 4044
Orange	+61 2 6361 9166
Port Macquarie	+61 2 6583 1735
Scone	+61 2 6544 3144
Wollongong	+61 2 4227 3022

Victoria

Melbourne Stockbroking, Corporate Advice, Wealth Management	+61 3 9947 4111
Brighton	+61 3 9519 3555
Camberwell	+61 3 9813 2945
Domain	+61 3 9066 3200
Geelong	+61 3 5222 5128
Richmond	+61 3 9916 4000
South Yarra	+61 3 8762 1400
Southbank	+61 3 9037 9444
Traralgon	+61 3 5176 6055
Warrnambool	+61 3 5559 1500

Australian Capital Territory

Canberra	+61 2 6232 4999

Northern Territory

Darwin	+61 8 8981 9555

Tasmania

Hobart	+61 3 6236 9000

Western Australia

West Perth Stockbroking, Corporate Advice, Wealth Management	+61 8 6160 8700
Perth	+61 8 6462 1999

South Australia

Adelaide	+61 8 8464 5000
Exchange Place	+61 8 7325 9200
Norwood	+61 8 8461 2800
Unley	+61 8 8155 4300

290119

morgans.com.au