Investment Watch

May 2019

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Welcome

Equity markets continue in an upward trend as expectations of rate cuts firm up following the weak Q1 inflation data. Economist Michael Knox explains why he believes there's a case for two rate cuts this year and we look at the implications of this for asset allocation. We retain a cautious stance and see opportunities in the Healthcare sector to protect portfolios. The Buy Now Pay Later space has received significant investor interest as more players enter the market. This month, we look at the opportunities in this space and highlight the key players.

Recently published research

- National Australia Bank – Full impact of CEO departure yet to come? (30/4)
- Flight Centre – Australian Leisure continues to be a drag (26/4)
- Viva Energy – Signs of life in refining (29/4)
- Coles – 'Fresh Stikeez' provides a boost (29/4)
- Westpac – Result shows stock is undervalued (6/5)

In this issue indicates published research available online.

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Offer Open
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Broker Firm Offer Close
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Settlement
Friday, 7 June 2019

ASX Listing
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Economics – room for the RBA to cut

Back in the 1990s, an RBA researcher called Glenn Stevens did a study about the average level of inflation that had been achieved by the Federal Reserve since the early part of the decade. He found that the Federal Reserve was achieving an average annual CPI result of some 2.5%. When the RBA came to set its inflation target, this average rate of 2.5% turned into an Australian inflation target of between 2% and 3%.

This target of between 2% and 3% is still the official target for the RBA. However, the current Governor, Philip Lowe, has the job of hitting that target as an average number through the business cycle. The target is now a medium-term target and not a short-term target.

What to do about inflation

The obvious solution to low inflation is that the RBA has to run interest rates low enough to push inflation up. We have a model of the kind of cash rate this would take. This model is not just based on inflation. It is also based on inflation expectations. The problem is not just that inflation is low. It is that the market believes that inflation will stay low.

With inflation and inflation expectations as low as they are, our model tells us that we need a cash rate of 98 basis points - let's say 1%. The cash rate of 1% is 50 basis points lower than the current cash rate of 1.5%. The RBA needs to cut the Australian cash rate to 1%.

When might the RBA act? The reality is the RBA can act anytime it likes. The practice of recent years is for the RBA to cut in steps of 25 basis points, a minimum of three months apart. When might the RBA begin to cut rates? Well, the next opportunity is the meeting in June. It is entirely up to the RBA which month it chooses.

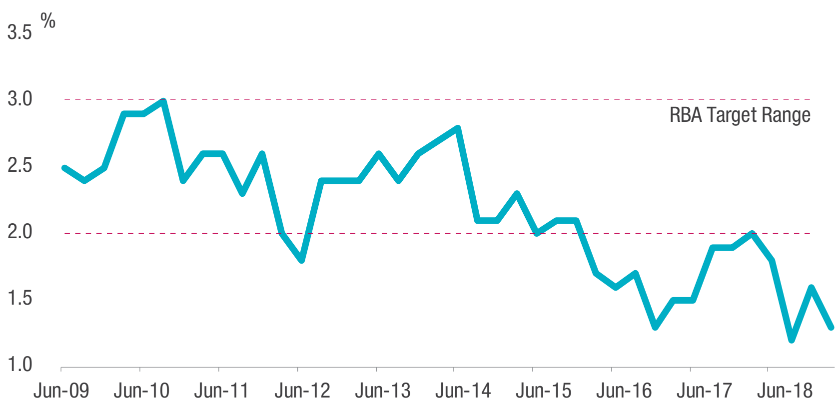
When it makes its choice of the first cut, we can expect the second cut to follow a few months later. This would mean a second cut following in September or October.

Conclusion

Inflation is too low, and the RBA needs to cut the cash rate. The first cut in the cash rate is likely to be either in June or July. After such a strong rise in the stockmarket in the first quarter, we think the market is entering a point where stock selection will be paramount to gaining returns. We have moved from a stockmarket to a market for stocks.

Refer to our Chief Economist's recent publication **Room for the RBA to cut** published 1 May 2019
bit.ly/2LIE8un

Australia CPI ex-volatile items



Sources: Morgans, Factset, ABS

Equity strategy

What a rate cut means for markets

Last quarter's Inflation print fell well short of the RBA's target range of 2-3% underlying inflation. The softening in underlying inflation now gives scope for the RBA to cut interest rates which was hinted in the recent RBA board minutes (2 April) "that inflation did not move any higher and unemployment trended up, noting that a decrease in the cash rate would likely be appropriate in these circumstances". Q1 CPI was flat in quarterly terms which meant that annual headline inflation fell sharply from 1.8% in Q4 to 1.3%. More importantly, trimmed mean inflation declined from 1.8% to 1.6%, the lowest rate since 2016 and below the RBA's expectation of 1.75%.

The outlook is now similar to early-2016 when the Bank cut rates on the back of weak inflation data despite steady improvements in the labour market. So there is a risk that the RBA cuts rates and potentially earlier than the market expects.

What does this mean for the Economy?

A lower level of interest rates could still be expected to support the economy through a depreciation of the exchange rate and by reducing required interest payments on borrowing, freeing up cash for other expenditure. With the fall in Major Bank funding costs the capacity for them to pass on at least one rate cut in full should help shore up the demand side of the economy. However tighter lending standards will limit the economic boost from rate cuts and tax policy and fiscal stimulus are likely to have more influence than the RBA cutting policy rates on the outlook for the Australian housing market and economy.

What does this mean for the Major Banks?

The fall in funding costs and the out-of-cycle increases to lending rates in the back half of 2018 have eased pressure on margins for now and we see scope for banks to fully pass through one rate cut in its entirety. We think any subsequent cuts will be passed on in the vicinity of 50-60%.

We believe it would not be wise for the RBA to wait for system home loan growth to get much softer as we are of the view that if system home loan growth drops to 3% pa then there is a high probability of a recession on the east coast. We forecast home loan growth to pick up to c5% over the next two years assuming monetary policy support does come through with some fiscal support.

However, we see limited scope for banks to fully pass through interest rate cuts if funding spreads widen. For this reason, we expect the RBA to first assess the effectiveness of a potential cut and consider the introduction of innovative tools - refer to our Bank analyst's recent note (Unconventional monetary policy is knocking).

We think the impact of lower risk free rates will be the key driver for major bank valuations moving forward. With significantly dovish shifts in the monetary policy stances of the US Fed Reserve and the European Central Bank (ECB), and with the RBA also adopting a more dovish tone in our view, bond yields have generally declined across the developed world including Australia. Our view is that this will translate to Cost of Equity Capital (COEC) compression for the major banks over the next 12 months and we expect this to be one of the key drivers of share price upside over this period; this is particularly the case as we expect no cuts in nominal dividends for the major banks with the exception of NAB.

Westpac is looking most compelling on a valuation basis as it is currently being priced off a COEC over 11%.

How does this affect sector positioning?

In terms of broader investment trends, a rate cut will prolong the chase for yield and growth as the low interest rate environment will tempt investors into the higher returning asset classes. We think assets such as Banks, Infrastructure and REITs that offer high and sustainable dividend yields will find support. Our cross asset portfolio offers our best defensive yield exposures (5.5% return over the past 12 months). Elevated asset valuations continue to be a hallmark of the Post-GFC period on the back of lower interest rates.

12 week performance follow rate cut

	ASX 100	Banks	Industrials	Telcos	REITS	Utilities
3/08/2016	-1.9%	3.3%	6.8%	-15.3%	-12.5%	-11.5%
4/05/2016	5.1%	2.1%	10.0%	2.4%	7.2%	9.4%
6/05/2015	-1.2%	0.8%	-13.1%	2.7%	2.2%	-1.1%
4/02/2015	1.1%	1.1%	-0.7%	-2.5%	-2.9%	3.8%
7/08/2013	8.4%	13.1%	7.6%	3.4%	2.4%	1.9%
8/05/2013	-2.8%	-2.9%	-2.2%	-1.5%	-8.3%	-4.4%
5/12/2012	11.4%	15.1%	5.7%	5.9%	7.1%	9.5%
3/10/2012	4.4%	3.6%	3.2%	10.7%	2.9%	5.3%
6/06/2012	7.4%	14.7%	-0.4%	4.8%	5.9%	2.6%
2/05/2012	-7.0%	-1.1%	-19.8%	8.2%	1.6%	5.0%
7/12/2011	0.1%	-1.5%	1.0%	1.7%	-0.6%	1.6%
2/11/2011	2.1%	1.2%	1.3%	8.1%	6.3%	7.2%
Average	2.3%	4.1%	-0.1%	2.4%	0.9%	2.4%
% positive	67%	75%	58%	75%	67%	75%

Source: RBA, FactSet

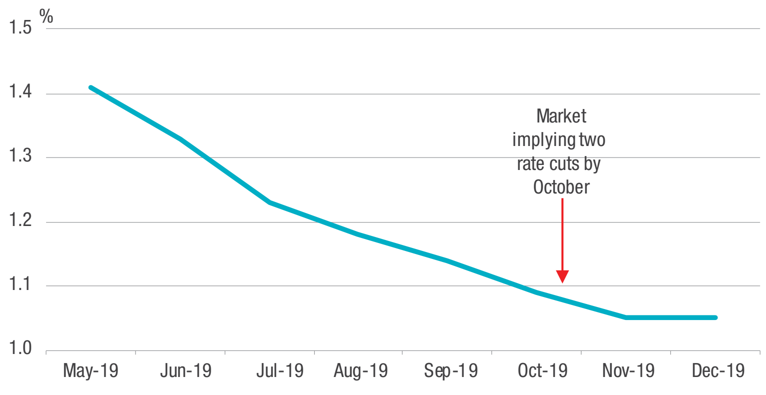
The market generally reacts favourably to lower rates, which should be welcome news to investors

Since the start of the year, the market has trended higher as Central Banks have shifted monetary policy to a neutral or accommodative bias. With the potential for the RBA to further cut rates, we expect the market to continue to trade at a premium particularly offshore growth opportunities (our preferred exposures include RWC, SHL, RMD, CTD, MQG, TWE) and sustainable yielders. It's clear the market had been anticipating this with the outperformance of IT, REITs, Staples, Infrastructure, Banks over the past 4 months.

There have been 12 RBA cash rate cuts since the GFC and in the table below we show the performance of sectors the 12 weeks following a rate cut.

We note that the market generally reacts favourably to lower rates which should be welcome news to investors. Healthcare services, Banks, Utilities, and Telcos are all strongly correlated to positive market performance.

OIS Implied RBA Cash Rate



Sources: Bloomberg, Morgans (Data as at 2 May 2019)

FinTech – decoding the ‘Buy now Pay later’ sector

The buy now, pay later (BNPL) sector has seen significant share price appreciation in recent times. Both Afterpay (APT) and Zip Co (Z1P) have been delivering >100% transaction growth year-on-year, which has made them stand out in a market thirsty for growth. They have also benefited from the completion of recent regulatory reviews into the BNPL space, with the sector left largely insulated in regards to regulation.

While APT and Z1P offer similar products (akin to a modern day Lay-by), there are clear differences in their offering and strategy. APT is essentially targeting millennial customers (<34 years of age) who are looking to buy smaller value items (<$200), with APT’s strategy involving expanding rapidly offshore (the US and imminently the UK). Z1P, on the other hand, sees itself more as competing against credit cards, with its revolving credit facility aimed at capturing a significant amount of customer every day spend. Z1P, therefore, is currently focused on the domestic market opportunity (including NZ), which it deems as substantial.

The attractiveness in the offerings of both stocks is why we have been comfortable having both companies on ADD recommendations. However, with Z1P having rallied almost 100% since its recent capital raising, we prefer APT in the near term. We see APT’s impending announcement of formally beginning operations in the UK as a clear stock catalyst (likely before the end of FY19).

Refer to note **Spending to grow** published
26 February 2019
bit.ly/2Lt9LaS

Recent initiations

Bingo Industries (BIN) ADD TP A$2.06	Bingo Industries makes money by providing waste collection and processing services with a focus on recycling.
Treasury Wine Estates (TWE) ADD TP A$18.65	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.
Atomos (AMS) ADD A$0.90	AMS is a founder-led video technology company that designs and sells video monitor recorders, a device that enhances quality and recording capabilities.

Healthcare – time to get defensive

As the market is trading around 10-year highs and the brief 4Q18 bear market sell-off fades into a distant memory, you could be forgiven for looking to high PE, momentum names as continued outperformers. However, in the words of Warren Buffett, “be fearful when others are greedy and greedy when others are fearful”. So given the current state of the market, we believe some caution is prudent and view now as the perfect time to better insulate portfolios from inevitable pullbacks with defensive positioning.

We believe the Healthcare sector has all the right ingredients. While we continue to view household names like CSL (blood plasma), Cochlear (cochlear implants) and Ramsay Health Care (private hospitals) as core holdings, CSL and Cochlear are at the upper end of our valuation and we think offer better value around $170 and $160, respectively. Ramsay is exposed to challenging operating environments and increasing domestic regulatory risk, with a price around $50 a good entry point.

Interestingly, these concerns are unusually absent for the primary care/pathology/diagnostic imaging providers, **Sonic Healthcare, Healius, Capital Health** and **Integral Diagnostics**. In fact, the recent Federal Budget flagged favourable changes to funding for primary care and diagnostic imaging. And as the nation turns more attention to the upcoming 18 May Federal election, both major parties have tabled further funding across these categories, with the Coalition promising A$1.1bn in primary care and A$309m in diagnostic imaging, and with Labor proposing a A$2.3bn Medicare cancer plan over four years and upping the ante in diagnostic imaging, with A$600m slated to cover all out of pocket payments. So, it would appear no matter which party comes to power, names across this segment look well positioned and key beneficiaries of favourable government policies.

Sonic Health Care
ADD PT A$28.00
1H beat –
Tracking to plan

Healius
ADD PT A$3.15
1H soft –
But it’s always darkest before dawn

High Conviction Stocks

The market looks vulnerable to some profit taking, but we continue to identify opportunities amongst the noise, including in key large caps Westpac, Oil Search, Reliance Worldwide, ResMed and Sonic Healthcare. After strong share price appreciation we take profits in PWR and Volpara this month.

Refer to our High Conviction update for more **bit.ly/2LvrIWp**

ASX 100	Ticker	Price	Price Target	FY20 Dividend Yield	FY20 Gross Yield	FY20 PE (x)	12m TSR
ResMed	RMD	$15.93	$17.34	1.5%	1.5%	27	10%
Sonic Healthcare	SHL	$26.35	$28.00	3.5%	5.0%	20	11%
Reliance Worldwide	RWC	$4.61	$5.56	2.2%	3.2%	20	24%
Westpac	WBC	$27.06	$33.00	7.0%	10.1%	11	32%
Oilsearch	OSH	$7.44	$10.62	2.8%	2.8%	15	46%
Ex-100	**Ticker**	**Price**	**Price Target**	**FY20 Dividend Yield**	**FY20 Gross Yield**	**FY20 PE (x)**	**12m TSR**
Kina Securities	KSL	$1.15	$1.31	15.0%	15.0%	5	29%
Senex	SXY	$0.35	$0.53	-	-	43	52%
Australian Finance Group	AFG	$1.19	$1.80	9.9%	14.2%	7	65%

Sources: IFactSet, IRESS, Data as at 7 May 2019

Indicates published/linked Research Note

Technical corner – PWR

Vulnerable to a pullback

- PWH has been trading in a strong up trend since August 2017 which is still technically intact.
- A large bearish divergence between the price and the RSI indicator has formed on the weekly chart showing that the long term up trend is losing momentum.
- A small descending triangle (a bearish formation) has formed on the daily chart suggesting that the price is vulnerable to a pullback in the short term.
- A break below minor support of $3.75 is likely and could trigger a fast sell off to $3.50. Given the bearish setup on the charts, active clients may consider trimming positions.

PWR Holdings Ltd.

Source: IRESS, Data at 7 May 2019

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