Investment Watch

February 2020

Welcome

A strong finish to 2019 saw the ASX 200 Accumulation Index up 23%. Growing confidence in the outlook for the economy and a strong bounce back in house prices lifted investor appetite for domestic equities. While 2020 has started on a positive note, we caution investors against extrapolating the strong returns of 2019, given a lot of the good news, we believe, is priced into earnings with valuations at record highs. This month we look at the outlook for the key economies of the US, China and Australia. We also preview the important reporting season, which provides an opportunity for investors to gauge how corporate Australia is faring.

Recently published research

Australia Strategy	(23/1)	Reporting season preview
Australia Strategy	(23/1)	ASX 100 playbook
Australia Strategy	(23/1)	ASX ex-100 playbook
IAG Group HOLD PT A$7.11	(27/1)	A triple hit
BHP Group HOLD, TP A$36.27	(22/1)	May need to make up ground

In this issue indicates published research available online.

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Equity strategy

Reporting Season Preview

Record market highs confound the fundamental headwinds from weaker earnings expectations. Logic suggests February results look far more likely to generate downside rather than upside price risk, but we argue how this disconnect may weather another uninspiring profit season.

EPS trends versus record valuations leave little room for error

FY20 EPS growth expectations for Aussie companies (ASX200 ex-Resources) have eroded from around 6.1% post the August 2019 results to only ~2.2% now. Remediation required of the major banks is a key driver, but the broader trend has been persistent for 2-3 years. Overall, we expect the market's most important 'portfolio' stocks (CBA, TLS, TCL, SYD) to deliver robust results in February, but that overall aggregate market earnings growth will erode into negative territory for FY20. This will likely test the nerve of record valuations (ex-Resources) trading at 19.3x 12-month forward PE, versus the 10-year average of 14.4x. Results look far more likely to generate downside rather than upside price risk in our view.

Reporting season playbooks and best tactical ideas

The Morgans ASX100 and Ex-ASX100 reporting season playbooks provide more detail on individual stocks. These preview result expectations for the 174 stocks under Morgans' coverage that report with a June or December financial year-end and detail 23 stocks expected to react positively and 22 negatively. From these, the best looking tactical buys include BHP, RIO, Telstra, Aurizon, and Baby Bunting. Stocks that are both expensive and where their results may disappoint include Wesfarmers, AGL Energy and Qube. See the playbooks for full details.

What to watch in February

- **Impact of fire and drought** – while several companies have already issued trading updates, we expect further updates from affected sectors (retail, agriculture and travel).
- **Surging iron ore price** - elevated earnings, a lack of capex commitments and healthy balance sheets have combined to see BHP/RIO with sizable ammunition to lift their dividend payout ratios and/or pursue buybacks.
- **A turnaround in global growth** – outlook will be key as recent global PMIs and economic surprise turns positive (ANN, AMC, STO, WPL).
- **Regulatory risk** – ongoing inquiries into the financial sector and ACCC M&A outcomes will be key catalysts to watch amongst the results (LNK AFG, TPM).
- **Growing structural threats** – shifting consumer behaviour and structural headwinds continue to affect several industries (WOW, COL, TLS, TPM, AGL, MPL, NHF).

Best tactical calls into reporting season

	Company
Earnings upside risk	AFG Group, Baby Bunting, Infigen, Adairs
Stronger outlook/ Catalysts	Telstra, Afterpay, QBE, Santos, Generation Development, IDP Education, Mainstream, Promedicus, Megaport
Compelling value	Kina Securities, Adairs, Intega
Capital management	BHP, Rio Tinto, Aurizon

Source: Morgans

Economics – 2020 outlook for US, China and Australia

United States

The outlook that I have for 2020 is sombre but strong. The Federal Reserve is trying to keep the US economy growing at a slower pace than it was last year and the year before. They plan to stabilise unemployment at the current low level of about 3.5% first and then let it drift up over the next few years, to a level they think is the long-term stable level. This, of course, has been called the natural rate of unemployment.

We have slow but solid growth in the US economy in 2019 and 2020. GDP growth of 2.1% is the blue-chip consensus, followed by 2% the year after that. Growth should fall to 1.7% in 2022 but that's forever away in stock market terms. Inflation headline CPI in the US should come in at about 1.8% in 2019 and consensus is 1.8% in 2020 and the year after. So what you've got is solid growth with low inflation in the US. Is that too optimistic? We'll find out as we go through the year but it's a very encouraging outlook.

China

In China, 2019 is the first year that we'll see below 6% growth. I think for the full year it'll come in at about 5.9%. It's modestly weak as we come to the end of the year and I think growth drops to about 5.6% in 2020 and the year after - although the impact of the Coronavirus may put some further downside risk to these numbers. Those growth numbers don't matter much for Australian exports to China. What's important is the level of Chinese steel production and that's growing very slightly higher than GDP. If you're producing a billion tonnes of steel and that's going up by 6%, that still is an enormous increase in the amount of iron ore needed to ship to satisfy that demand; also, the amount of metallurgical coal. That's what we do with China, just the sheer size of that demand and its continuing growth even at 5.6% or 6% generates as much as we can produce at our current level of capacity.

Thus, it looks like there is going to be more investment in mining, particularly iron ore, in the year ahead.

Chinese inflation kicked up in 2019 (2.2% in 2018 to 5% in 2019) almost entirely because of the increase in pork prices due to the outbreak of Asian swine fever. This rate of increase in prices seems to have peaked at least every month to November and is gradually slowing down. I think that inflation in China will be 5% in 2019, slowing to 2.8% in 2020.

An enormous herd of swine has been affected by African swine fever which meant a significant amount of the herd had to be destroyed. Thus, the domestic production of pork has fallen. This causes problems with prices and consumer price inflation.

Australia

The Australian economy is far better than it looks, in terms of GDP. The current level of growth in the last quarterly accounts was 1.7%. However, if I look at the measure of real gross disposable income (which is the amount of money households have available to spend after tax), that went up by 4.8%. If I look at nominal GDP, that went up by 5%. It is nominal GDP that drives tax revenue and corporate profits. I think that even though the published GDP number looks weak, the Australian economy is in pretty good shape. I think that published GDP will be 2% in 2019 including the December quarter, rising to 2.8% in 2020 and 3% the year after.

Inflation remains stable at 1.8% in 2019 and in 2020, and that means that our forecast interest rates will include another rate cut to 50 basis points. Rates should then stay there throughout the year. So that's splitting the difference between what the market thinks and what the RBA thinks. The RBA thinks the economy is in pretty good shape, the market thinks it's in need for help, so we forecast one further rate cut but it'll stabilise there.

Equity Market Outlook

Our fair value for the ASX200 has come down a bit by about 80 points. The reason for that is the modest increase in the Australian ten-year bond yield. Our fair value is now 6,590 or moderately overvalued at current levels but not extremely overvalued. The US market is a little more overvalued. I think fair value there is 2,861 based on current operating earnings per share but trading at 3,192 it's 330 points too high. You need to get about 500 points too high before you get scared of a major sell-off. Fundamentals should improve in 2020.

Expectations for US earnings are pretty good. I'll briefly break down the structure of the US equities market and how radically different it is to Australia's. It's useful to look at the top four sections of operating earnings per share in the S&P 500. I've got both the current quarter's numbers and the forecast for the next quarter in 2020. I'll talk about this in terms of the quarters in 2020, but the proportions don't change much going forward. The overwhelmingly largest section of US earnings in the S&P 500 is Information Technology, which generates

For more economics coverage subscribe to the bit.ly/IW-Jan-2020-Michael-Knox just under 22% of all the earnings. That's followed by financials, which lose about 1% in terms of their proportions of US earnings between 2019 and 2020 but they're still 17.8% of US earnings in 2020. Healthcare is stable at 15.5%, and communications is pretty much stable at 10.5%. That means those four sectors comprise 66% of all the earnings in the S&P 500. That's a very different composition than we have in Australia.

Now, the consensus forecast is that those earnings are going to go up by 13.3%, that's bottom-up earnings estimates by analysts. I think that's too strong. A simple rule I've used with earnings in the US economy since back in the day is that earnings grow about four times GDP. As I anticipate that US GDP will grow by 2%, it's reasonable to expect that US earnings will grow by 8%, so still positive but not as strong as the market anticipates. It's that anticipation that may be generating overvaluation at the moment.

Australian Economic forecasts – end of 2020

	Morgans	Bloomberg Consensus
GDP Growth	2.8%	2.2%
Inflation	1.8%	2.0%
RBA Cash rate	0.5%	0.5%
Aussie dollar	71c	70c
ASX 200	6590	6700

Source: Morgans

Currency

The way currencies work is that the currency which tends to lead the world system is Sterling, and Sterling leads the world system because Britain is a banking system with a country attached. It is also the banking system which is the world's largest centre of foreign currency trading. Thus, if you see an increase in international liquidity which may feed through to commodity prices, you see it first in Sterling. And what we've seen is a very remarkable kick in Sterling over the last half of the year. What that tells you is that we're coming into a period of expanding growth in international liquidity which in turn will drive up commodity prices.

Sterling leads as an international currency. Sterling leads the Euro, the Euro leads the USD index/DXY and the DXY leads the Aussie dollar and also commodity prices, particularly oil prices. You can approach the issue of currency and commodities in two ways. Firstly, structurally you would expect the USD to go down because the US' budget deficit is 5.5% of GDP now and forever as far as the forecasting horizon exists. That would tend to put downward pressure on the real USD exchange rate, therefore, putting up commodity prices. If you want to look at a timing approach, look at Sterling first and then the Euro, then the DXY, then you'll see how those lead commodity prices and the Aussie dollar. I think the net result of this is that over 2020, the USD is going down, the Aussie dollar is going up and commodity prices are going up as well. I particularly think there's an upside in oil.

Conclusion

In short, US earnings look pretty good, although not quite as good as the market anticipates in 2020. US growth should be a solid 2%. In China, it should be a reasonable 5.6% and in Australia, it should be better than we currently anticipate, which is 2.8%. I think that generates an outlook which is sombre but strong.

Industrials – gearing up for a cyclical recovery

We remain cautiously optimistic about the Industrials sector in the year ahead. There are clearly some domestic headwinds due to a sluggish economy and subdued consumer sentiment. However, interest rates are at historical lows and if the rebound in house prices can be sustained, then this could brighten the mood and get consumers spending again after a devastating bushfire season. In general, we feel conditions are still conducive for growth but as always, we prefer to stick with high quality companies with strong competitive advantages, a capable management team and a solid balance sheet.

Our key pick in the large caps space remains **Orora**. We acknowledge that the stock has underperformed the broader market over the past 12 months but believe the issues the company has been facing have largely been resolved. The balance sheet remains strong providing ample capacity to pursue organic and inorganic growth opportunities. The pending A$1.2bn capital return should also support the share price in 2020.

In the small caps space we continue to like PWR Holdings. PWR is the world leader in cooling solutions, supplying its products to a range of industries including the highly demanding Formula One racing category. The company boasts the majority of Formula One teams as customers, which highlights the quality of its products. PWR has experienced strong growth over the past five years and we expect this to continue.

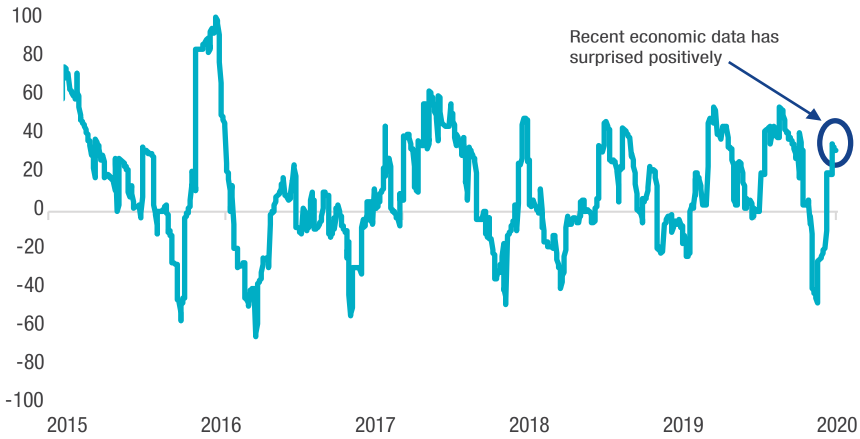
For investors wanting exposure to the growth in infrastructure spending, we recommend Acrow Formwork and Construction Services.

Orora
ADD TP $3.34
Result preview

PWR Holdings
ADD TP $5.30
Result preview

Acrow
ADD TP $0.40
Result preview

Australia Citi Economic Surprise Index



Source: Morgans, Factset

Recent initiations

MoneyMe (MME)
ADD PT A$1.79
MME is a consumer credit business that utilises its digital presence and technology platform to offer innovative loan products.

Mach7 (M7T)
ADD PT A$1.16
M7T is a provider of enterprise imaging management systems for healthcare organisations.

isentia (ISD)
ADD PT, A$0.43
ISD is the dominant media intelligence and insights solutions provider in Australia/New Zealand and the largest provider in a fragmented Asian market.

Beach Energy (BPT)
HOLD PT, A$2.29
BPT is an oil and gas producer with assets in the Cooper basin, Perth basin and, following the Lattice acquisition, it also has assets in Victoria, Tasmania and New Zealand.

Karoon Energy (KAR)
ADD PT, A$2.40
KAR is an oil and gas producer, developer and explorer. The company is in the last stages of finalising an acquisition of the Bauna oil field in Brazil, a mature field in the Santos basin.

Morgans best Ideas

Our best ideas 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 our most preferred sector exposures.

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Company	Sector	Size	Risk Profile	Price	12m Price target	Dividend Yield	Gross Yield	12m TSR
Telstra Corporation (TLS)	Communication Services	Large	Lower	$3.86	$4.46	4.1%	5.9%	20%
Woodside Petroleum (WPL)	Energy	Large	Lower	$34.64	$38.32	5.4%	7.8%	16%
Westpac Banking Corp (WBC)	Financials	Large	Lower	$25.31	$30.00	6.3%	9.0%	25%
Sonic Healthcare (SHL)	Health Care	Large	Lower	$31.50	$31.00	2.8%	3.2%	1%
Transurban Group (TCL)	Industrials	Large	Lower	$15.76	$14.67	3.9%	4.2%	-3%
Aurizon Holdings (AZJ)	Industrials	Large	Lower	$5.45	$5.78	5.1%	6.6%	11%
APA Group (APA)	Utilities	Large	Lower	$11.41	$10.64	4.4%	5.0%	-2%
ResMed Inc (RMD)	Health Care	Mid	Moderate	$24.31	$22.82	1.0%	1.0%	-5%
Cleanaway (CWY)	Industrials	Mid	Lower	$2.02	$2.03	1.9%	2.7%	2%
Link Administration (LNK)	Information Technology	Mid	Moderate	$6.21	$6.68	2.8%	4.0%	10%
Orora (ORA)	Materials	Mid	Lower	$3.21	$3.34	4.0%	4.6%	8%
Frontier Digital Ventures (FDV)	Communication Services	Small	Higher	$0.93	$0.96	0.0%	-	3%
PWR Holdings Limited (PWH)	Consumer Discretionary	Small	Moderate	$4.70	$5.30	2.1%	3.0%	15%
Lovisa (LOV)	Consumer Discretionary	Small	Moderate	$11.28	$14.12	2.7%	3.9%	28%
Baby Bunting Group (BBN)	Consumer Discretionary	Small	Moderate	$3.37	$3.92	3.4%	4.9%	20%
Elders (ELD)	Consumer Staples	Small	Moderate	$7.26	$7.10	2.6%	3.7%	0%
Cooper Energy (COE)	Energy	Small	Higher	$0.56	$0.69	0.0%	-	23%
Kina Securities (KSL)	Financials	Small	Higher	$1.43	$1.65	9.3%	9.3%	25%
Generation Development (GDG)	Financials	Small	Higher	$0.86	$0.97	2.3%	2.3%	16%
Pro Medicus (PME)	Health Care	Small	Higher	$23.89	$32.79	0.5%	0.5%	38%
Volpara (VHT)	Health Care	Small	Higher	$1.83	$2.17	0.0%	-	19%
Over The Wire (OTW)	Information Technology	Small	Higher	$4.41	$5.16	0.9%	1.2%	18%
IRESS (IRE)	Information Technology	Small	Moderate	$13.58	$15.42	3.5%	4.1%	17%
Orocobre (ORE)	Materials	Small	Higher	$3.17	$4.80	0.0%	-	52%
Red 5 (RED)	Materials	Small	Higher	$0.29	$0.50	0.0%	-	73%
Aventus Group (AVN)	Real Estate	Small	Lower	$2.88	$2.86	5.9%	5.9%	5%
APN Conv. Retail REIT (AQR)	Real Estate	Small	Lower	$3.64	$3.62	6.0%	6.0%	5%

Source: Morgans, Data as at 31 January 2020

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