Investment Watch

Spring 2020 Outlook

morgans

Welcome

Australia escaped the initial onslaught of COVID-19 relatively lightly. The GDP decline in the June quarter, while a substantial 7.0%, was rather less than the 9% or so experienced by the median OECD economy. It was however enough to do substantial damage to corporate earnings in FY20 and to pose ongoing risks to improved profitability in the future. The unequal nature of the recovery and the potential for a resurgence of COVID-19 offshore will mean investors will need to position portfolios for resilience. We cover the outlook for Banks, Retail, Telco and Property in this edition. We continue to expect the market to make further gains, but we are preparing for a more turbulent ride ahead. We also pick apart the opportunities in the Listed Investment Trusts and update our Asset Allocation benchmarks.

Recently published research

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Recent corporate offers

Generation Development Group Limited (ASX:GDG)

Morgans would like to congratulate Generation Development Group, its Board and management team on their strategic capital raising and acquisition completed by way of an Underwritten $35 million placement and accelerated entitlement offer where Morgans acted as Joint Lead Manager, Bookrunner and Underwriter.

Generation Development is a pooled development fund which focuses on the investment bonds market where it has delivered fund growth of 22% CAGR over the past three years, and ranking as number one in market inflows with ~38%, delivering shareholders EPS growth CAGR of 41% over the past three years.

Company website
gendevelopmentgroup.com.au

MyDeal.com.au Limited

Initial Public Offer at $1.00 per share to raise $40 million

Founded in 2011, MyDeal.com.au Limited ("**MyDeal**" or the "**Company**") is an Australian e-commerce group that has successfully established an Australian online retail marketplace specialising in household goods such as furniture and homewares. MyDeal operates a marketplace model that acts as an intermediary, facilitating transactions between consumers and sellers. MyDeal has developed proprietary technology which allows the marketplace to scale quickly whilst still retaining a low-cost operating model.

MyDeal has over 800 active sellers and over 5 million product SKUs across 2,000 categories. Over 1 million products were sold in FY20 on the platform. The Company has established a private label offering and intends to utilise its proprietary marketplace data to help grow this offering efficiently, whilst also driving gross margin for the MyDeal business. The Company is backed by an experienced founder-led management team and Board who have highly relevant industry experience allowing for effective governance and oversight.

Morgans Corporate is a Joint Lead Manager and Underwriter to the Initial Public Offering.

Key Dates

Offer Close – 5:00pm Monday, 12 October 2020

Expected Listing Date – Thursday 22 October 2020

Company website
mydeal.com.au

Economics – quantitative easing as a long-term strategy

On 22 September 2020, Deputy Governor of the Reserve Bank of Australia Guy Debelle, delivered a paper to a virtual conference of the Australian Industry Group titled “The Australian Economy and Monetary Policy[1]”. He covered a range of topics including the Australian economy, the effectiveness of monetary policy thus far and the outlook for further monetary policy action. We focus on the various monetary policy actions by the RBA in this article.

The Deputy Governor notes that the various monetary policy actions by the RBA have led to a significant increase in the size of the RBA’s balance sheet from A$170bn in February to A$300bn currently which we calculate as 15% of Australian GDP. Two major causes of the increase in the size of the RBA’s balance sheet have been two forms of quantitative easing. The first is as a direct consequence of the bank’s purchase of government bonds. When the Reserve Bank buys bonds in the secondary market, it directly boosts the banking system’s deposits.

Secondly, there was an increase in the Reserve Bank’s balance sheet by funds provided under the Term Funding Facility (TFF). This has substantially increased liquidity. These funds are lent by the RBA to the banking system for a term of three years and at a fixed rate of 25 basis points. The TFF in Australia sits within that category of quantitative easing, which in other countries has been called ‘funding for lending’.

What is the impact on the take up by the banking system of the TFF?

The TFF has lowered lending rates by lowering bank funding costs. The TFF funding is considerably cheaper than wholesale funding of a similar maturity. Second, the TFF is having a noticeable effect on the composition of bank funding. One result has been a reduction in offshore wholesale funding, which is a very similar size to the take up of the TFF.

Being able to access money from the TFF at only 25 basis points makes this a much, much better deal than borrowing funds offshore in the US wholesale market. Australian banks would be wrong not to take up money from the TFF and instead raise money in the US wholesale market.

Debelle notes that the final element of the board’s package is the target rate for the three-year Australian government bond yield. This is a price-based target for bond purchases rather than a quantitative target for bond purchases announced by many other central banks. He notes that we can think of this as an extension of the cash rate target. In this case, where the target is for three years rather than overnight. That increased horizon for the target is aligned with the banks’ forward guidance.

How long will quantitative easing continue?

The Deputy Governor noted that the three-year yield target for Australian three-year bonds is aligned with the board’s guidance about the future direction of the cash rate. It will keep buying bonds as long as it wants the cash rate to stay at the current level. He goes on to say, “The board has stated consistently that it will not increase the cash rate target until progress is made towards full employment and it is confident that inflation can be sustained within the 2%-3% target band”. The bank expects that unemployment will rise to 10% at the end of 2020 and gradually decline to 7% by the end of 2022. He notes there would still need to be a further decline in the unemployment rate before the Australian labour market would be nearing full employment.

He notes that prior to the pandemic, the unemployment rate was about 5% but even this low level was not low enough to generate sufficient wage growth consistent with achieving the inflation target. Under the current scenario, it would be more than three years before adequate progress is being made towards full employment to be confident that inflation would be sustainably within the target band. He notes it is highly unlikely that the cash rate will be raised within that three-year time period.

How high can the RBA’s balance sheet go?

International comparisons tell us that the increase in the size of the Reserve Bank of Australia’s balance sheet could have a long way to run. The website of the US Federal Reserve shows us that as of August 12, the total size of the balance sheet of the Federal Reserve was US$7 trillion. This was 34% of US GDP. The balance sheet of the RBA rose to A$170bn in February or 8.5% of GDP to A$300bn now or 15% of GDP. This means that the current size of the RBA balance sheet is less than half of the current size of the US Federal Reserve balance sheet relative to GDP.

In Australia, quantitative easing is something new. It is natural to think that this won’t be maintained for long. The experience in other countries however reveals something different. When the Federal Reserve began quantitative easing in November 2008, it did not end that quantitative easing until almost six years later in September 2014.

Guy Debelle appears to suggest that quantitative easing will continue as long as the cash rate remains at its current low level. He doesn’t believe that the current low level of the cash rate will be moved until unemployment is at 5% or lower. In his address he says that he doesn’t expect unemployment will be at 7% until the end of 2022. In this scenario, Australia will be beyond 2023, perhaps in 2024 before we gain an opportunity to start increases in the cash rate and bring an end to our program of quantitative easing.

Conclusion

Quantitative easing in Australia has two major components. The first is that the RBA will continue to buy Australian Government three-year bonds. The second is that the RBA will continue to expand the Term Funding Facility to provide funding for lending for Australian banks. Neither of these programs looks like they are coming to an end before 2024 at the earliest. Quantitative easing and thus low benchmark interest rates is now a long-term strategy of the Reserve Bank of Australia.

[1]The Australian Economy and Monetary Policy. 22 Sep 2020.

https://www.rba.gov.au/speeches/2020/sp-dg-2020-09-22.html

Morgans Economic Forecasts

	DEC-20	JUN-21
$A (US cents)	72 cents	74 cents
Cash rate (%)	0.25%	0.25%
GDP Growth (%, ANN)	-3.5%	0.5%
Inflation (%, ANN)	0.5%	0.8%
Unemployment rate (%)	6.1%	5.4%

Source: Morgans estimates

Under the current scenario, it would be more than three years before sufficient progress was being made towards full employment to be confident that inflation would be sustainably within the target band.

For more economics coverage, refer to our Federal Budget Review published 6 October 2020.

Equity strategy – a gradual path higher but be prepared for turbulence

For more, see our FY21 sector outlooks and strategies published 25 September.

Australia escaped the initial onslaught of COVID-19 relatively lightly: its GDP decline in the June quarter, while a substantial 7.0%, was rather less than the 9% or so experienced by the median OECD economy. It was however enough to do serious damage to corporate earnings in FY20 to pose ongoing risks to improved profitability in the future. The unequal nature of the recovery and the potential for a resurgence of COVID-19 offshore will mean investors will need to position portfolios for resilience. We continue to expect the market to make further gains, but we are preparing for a more turbulent ride ahead. We think the best gains will be driven by sectors that have largely underperformed so far (Banks, Ag/Food, Industrials and Energy). This would be something akin to what happened between mid-May and early-June when the economic recovery continued despite the virus, against a backdrop of ongoing policy support.

September quarter moves and opportunities

The ASX 200 tracked mostly sideways over the past quarter. Investors are struggling to reconcile the pace of the economic recovery amidst a spike in new COVID-19 infections. Traditional valuation fundamentals continue to be supported by a global flood of liquidity but the sell-off in US technology stocks in September should be a reminder to investors that the market is pricing certain sectors on a relative basis, rather than on an absolute view of return versus risk, which can be a dangerous dynamic. Remember no investor alive has witnessed this type of rates outlook nor this scale of stimulus first-hand, so while we think the market will move directionally higher over the next 12 months, be prepared for turbulence over the coming months. Some market moving events to watch for over the next few months include:

1. The partisan make-up of Congress following the November US Presidential election;
2. Approach to containing the re-escalation of COVID-19 outbreaks;
3. Risks to global trade/relations; and
4. Australian AGM season and trading updates.

We outline our current sector views and best ideas in the table opposite.

Key sector outlooks

Category	Sector	Sector Rating	Best Ideas	Analyst Overview
Financials	Banks	Improving	WBC, MQG	We think the bad debt experience from COVID-19 will be less severe than that experienced during the GFC as governments and central banks are cushioning bank and private sector balance sheets to an extent never seen before. As such we think share price damage in the banks looks overdone.
	Diversified Financials	Deteriorating	MFG, QBE, GDG, KSL, Z1P	The outlook remains very much shaped by a difficult economic environment and potential volatility. Remember that lower bond yields are a sector headwind and when combined with risks like elevated bad debts, we would expect investors to generally be more underweight the sector at this time.
Defensives	Cons. Staples	Neutral	COL, CCL	The panic buying at the start of the pandemic that led to record sales at Woolworths and Coles has moderated but remains at elevated levels. Supermarket sales should continue to benefit from higher at-home consumption, although costs are also higher and could limit operating leverage going forward.
	Healthcare	Neutral	RMD, VHT, M7T	We expect Healthcare's defensive characteristics to help sustain a premium rating, and the sector is a likely beneficiary of capital inflow should global COVID-19 concerns re-escalate, despite some stocks looking expensive.
	Telco	Neutral	NXT, TPG	Recent results suggest that deeper competition and a slower return to growth will continue to plague the traditional parts of the sector for longer. However, the outlook for companies directly exposed to the "from home" thematic has improved meaningfully (Data Centre, Network connectivity).
	Infra and Utilities	Neutral	APA, SYD	Exposure to regulated revenues (AST, SKI), or long-term take-or-pay contracts (APA) should remain in demand, however AGL and ORG continue to struggle with weaker wholesale electricity prices clouding the outlook. Ultimately, ultra-low interest rates can intensify the appeal of strong cash generators (SYD, TCL) once their volumes recover.
	A-REITs	Improving	AQR, WPR, AVN	Office REITs continue to be impacted by the work from home thematic. REITs exposed to residential housing/large-format retail are holding up better than expected supported by government stimulus. Industrial assets proved resilient and highlighted the increasing acceleration of online retail/logistics.
Cyclicals	Consumer Disc.	Improving	BRG, ADH, APE, SUL, ALL	We maintain a constructive position towards the sector given our view that robust growth will continue over the balance of 1H21 at least supported by the key sales periods (Cyber sales and Christmas) and FX tailwinds.
	Industrials	Improving	AZJ, AMC, ALQ, ACF, PWH, PPE	COVID-19 remains the key swing factor highlighting the defensive nature of parts of the sector (AZJ, AMC) while a gradual recovery from the pandemic is leading to a recovery in demand for key cyclicals (PWH, ACF, REH, RWC).
	Online media	Improving	RBL, CAT	Reporting season highlighted the attractiveness of the sector amidst the uncertainty of the pandemic. The acceleration of digital trends and the strength of capital light models with the ability to scale profitability leaves the sector well placed.
	Agri-culture	Improving	NUF, IPL, CGC	Dramatically improved seasonal conditions and a bumper winter crop outlook means the Ag stocks with solid balance sheets are a good place to invest amid ongoing volatility.
Resources	Metals & Mining	Improving	RIO, BHP, STA, ORE, RMS	Strong and sustained iron ore prices support compelling yields in the majors. Metals pricing has improved and looks set to benefit from building supply responses and demand recovery as economies re-open.
	Energy	Neutral	STO, WPL, SXY, KAR, BPT	Oil prices cannot remain at current levels indefinitely. Geopolitics is unfortunately a dominant and unpredictable influence on already concerning demand issues.

Negative Deteriorating Neutral Improving Positive

Banks – headwinds easing

While we recognise that the situation stemming from COVID-19 poses significant downside risk to major bank earnings and dividends, we believe the major banks sector offers good value at the moment. In particular, we believe the asset quality damage being reflected in current share prices, with the exception of CBA, is overdone. To put this into context, our credit impairment charge forecasts are more pessimistic than the major banks' 'severe downside' scenarios; FactSet consensus forecasts are more pessimistic than our forecasts; and we believe the damage reflected in current share prices is even more pessimistic than FactSet consensus forecasts. While we believe the damage reflected in current share prices is not worse than that experienced by the major banks during the GFC, at this stage, we do not expect the asset quality damage this time around to be as bad as the GFC due to the unprecedented level of government support in place for the economy and the unprecedented level of lender support in place for borrowers.

We are also more optimistic than FactSet consensus on the outlook for net interest margins for reasons including the following:

- We expect the bulk of term wholesale funding maturities leading up to 30 June 2021 to be replaced with much cheaper customer deposit funding and funding from the RBA's Term Funding Facility (TFF);
- We expect the major banks which have built up a supernormal level of liquid assets on their balance sheets over the last six months, to normalise liquid asset levels over coming months; and
- We see continued downward pressure on savings deposits and term deposit rates.

Westpac, with an Add recommendation, is our preferred major bank. **CBA**, with a Hold recommendation, is our least preferred major bank.

Ranking	Stock	Recommendation	Share Price	Target Price	Dividend Yield	Gross Yield	12m Forecast TSR
1	WBC	ADD	$17.41	$22.50	5.6%	8.0%	37%
2	ANZ	ADD	$17.89	$21.00	5.4%	7.0%	24%
3	NAB	ADD	$18.24	$20.50	4.8%	6.9%	19%
4	CBA	HOLD	$66.15	$66.00	4.0%	5.7%	5%

Source: IRESS, Morgans. Data at 7 October 2020.

Recent publications

NAB
ADD TP A$20.50
Sale of MLC will further strengthen CET1 ratio

WBC
ADD TP A$22.50
Expect final dividend to make up for no interim

ANZ
ADD TP A$21.00
Very strong quarter for Markets income

CBA
HOLD TP A$66.00
Quality retail franchise on show

Telco – two speed recovery

In theory, 2020 should mark the turning point for telcos where prices and returns start to rise. The NBN is nearing completion, TPG and Vodafone have merged, and 5G is gaining traction. Telstra's 5G mobile network will start to differentiate, especially once Apple release their 5G iPhone, in Q4 2020. 5G is the new shiny toy in the telco market and businesses and consumers will start to see the benefits of this in the next few years. However, this positive macro backdrop was overshadowed by commentary from Telstra in August 2020. Telstra told investors their return on capital target for FY23 has reduced from 10% to greater than 7%. Telstra attributed this to deeper competition and a slower return to growth. The investment market has interpreted this as meaning that competition will remain intense for many years to come. Consequently, the share price of both Telstra and TPG has come under pressure in this quarter.

While the outlook for traditional telecommunications hasn't improved as we had hoped, the outlook for companies directly exposed to the "from home" thematic, has improved meaningfully. There was a scramble from March to June to enable working and learning from home. We thought this might be a temporary spike and things would return to normal. Sadly, many countries and communities have remained in lockdown for an extended period. We are now seeing a step change in demand for digital services. Companies that facilitate working, learning, shopping and entertainment from home are likely to remain in high demand as the world digitises. NEXTDC is Australia's largest independent data centre company and a critical piece in the flow of internet traffic all around Australia. This quarter we upgraded NEXTDC to an Add recommendation.

Our key telco picks are **TPG Telecom** and **NEXTDC**.

Recent publications

NEXTDC
ADD TP $13.89
As easy as 1, 2, 3

TPG Telecom
ADD TP $8.71
Getting down to business

2020 Q4 asset allocation

We see risk assets making further gains as the global economy continues to recover, even if only gradually. We suspect that equities and currencies in parts of the emerging economies including Australia will be the best performers over the next 12-18 months. At the same time, we think that the yields on safe government bonds will remain around their current low levels. The recovery in risk appetite and the fall in US interest rates relative to those elsewhere will continue to weigh on the US dollar, although uncertainty about the post-virus outlook and the risk of a re-escalation of US-China tensions may keep the dollar from falling much further in the near term. Crucially, our forecasts rest on the assumption that the major economies continue to manage the coronavirus pandemic without slamming the brakes on activity again.

In line with our view that risky assets will continue to recover over the coming months, we think that credit spreads will fall further. This is because we expect the global economy to continue to rebound, which should be supportive of risky assets more generally. In addition, there is still plenty of room for spreads to decline against a backdrop of exceptionally loose monetary policy, direct purchases by central banks and an ongoing hunt for yield.

For equities, we continue to think that the ex US markets will outperform the S&P 500. This is because the former has higher weights in sectors like consumer discretionary, energy, materials and financials, which we think will fare better as economic activity slowly normalises. In fact, these sectors were also among the best performing between mid-March (when markets bottomed) and mid-June (when the number of cases in the US started to rise sharply again, prompting fears of renewed lockdowns). During this period of lockdowns, restrictions were gradually lifted in most countries and activity started to recover, which is what we expect to happen in the remainder of this year. What's more, the possibility that a Democratic 'clean sweep' could lead to higher corporate taxes is a key downside risk to US equities and increased risk aversion in the short term.

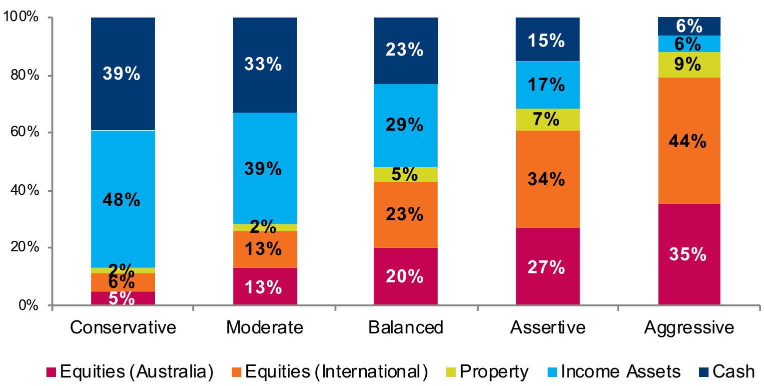
We neutralise our tactical underweight to equities (0%) and reduce our tactical underweight in income assets (-1%).

The Morgans Strategic Asset Allocation methodology takes a systematic approach in optimising exposure to the various asset classes at different stages of the Economic cycle.

Quick views per asset class

Equities	The largest, best capitalised and well managed franchises are best placed to weather reduced demand. Reliable income generators and any semblance of growth should retail a premium while the outlook for inflation (and rates) remains subdued, potentially for an extended period.
Listed property	The playing field may somewhat be re-drawn – particularly for retail – but the normalisation of human behaviour should re-instate demand for higher quality, physically scarce property. Industrial A-REITs continue to see strong leverage to the change in consumer channels (ecommerce, fresh deliveries).
Global infrastructure	Appetite for quality yield will only strengthen on the lower interest rate outlook. Infrastructure such as energy utilities and telecommunications have stood up to the risks prevailing in the global economy.
Listed fixed interest	Pricing has recovered somewhat in-line with a reduction in global volatility across all asset classes. We retain a preference for shorter-dated securities, particularly given price volatility and the returns currently on offer.
Government bonds	Australian Government bond yields continue to be depressed through monetary policy. We recommend that conservative investors stick to term deposits given the Government guarantee rather than make direct bond investments.
Term deposits	A number of financial institutions are offering special term deposit rates in the current climate as banks look to increase deposit funding.
Cash	Despite lower returns, we maintain a slightly higher cash weighting for capital preservation and to protect against downside risks.

Source: Morgans Research



	Conservative	Moderate	Balanced	Assertive	Aggressive	Tactical Tilts
Equities (Australia)	5%	13%	20%	27%	35%	0%
Equities (International)	7%	14%	24%	35%	45%	-1%
Property	3%	3%	6%	8%	10%	-1%
Income Assets	49%	40%	30%	18%	7%	-1%
Cash	36%	30%	20%	12%	3%	3%

Listed Investment Trusts – attractive entry prices and distribution certainty – LITs look cheap

Credit LITs are relatively new to Australian investors with the first (MXT) only launching in October 2017. So, it's not surprising that when markets sold off during the COVID-19 meltdown, investors panicked and sold LITs without reference to their true value. Simply, no one knew what to expect or how bad things would be.

Why wasn't this surprising? Looking back to the GFC we saw similar behaviour in bank issued capital notes (hybrids). Investors sold these securities without considering that in the absence of a bank failure (we didn't know how bad it would be), they would return to their par (face) value over time. Buying hybrids in that sell-off proved to be a sound investment; they continued to pay distributions and prices rose back to face value, enhancing investor returns.

We can look at LITs through a similar lens. We know that the NTA of a LIT represents the value of the underlying assets. Where the underlying assets are traded (e.g. bonds), the NTA will change in line with the traded price of those assets. LITs with few or no traded assets will see little or no change in the NTA (e.g. MXT). Encouragingly, GCI which does hold traded assets has seen virtually no change in its NTA. This is due to the quality and price stability of the underlying securities. Other LITs though, have seen significant changes in their NTA; importantly all have improved as markets have stabilised which is a positive sign and confirms to us that the institutional market's assessment of the underlying assets has improved significantly.

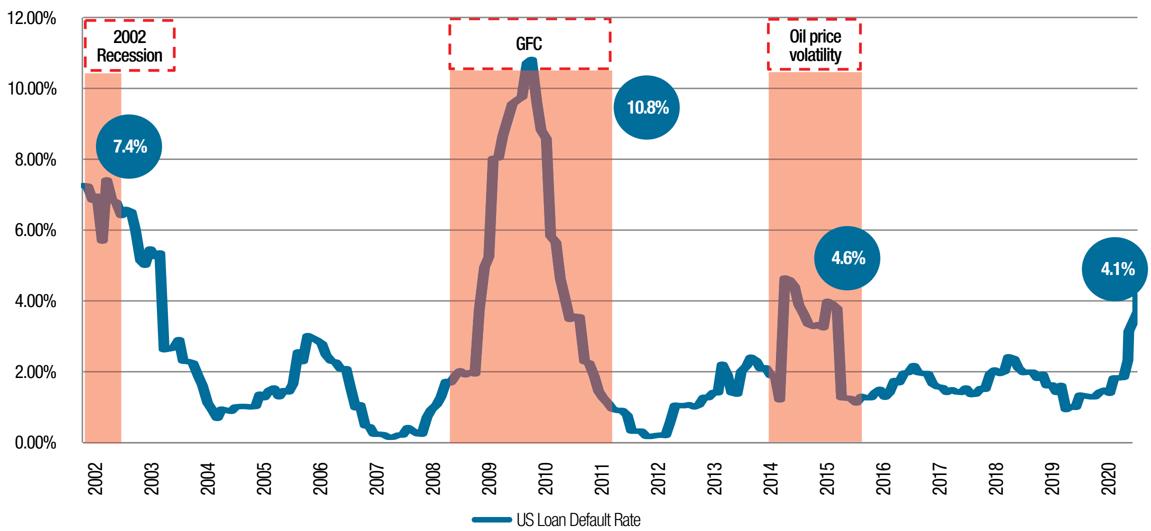
What is perplexing though is that the traded prices of LITs remain below their NTAs. If we accept that the NTA represents the true value of the underlying investments, then there is no logical reason for the ASX unit price not to be at least equal to the NTA price. If investors are concerned that there might be losses to come in a LIT portfolio, then this should already be reflected in the published NTA.

Investors who dismiss what the NTA is telling us, are in fact saying they know more about credit markets than the investment professionals who trade these markets each and every day.

Looking at historical loan default rates, during the GFC they reached circa 10% which is far worse than what has been experienced this time.

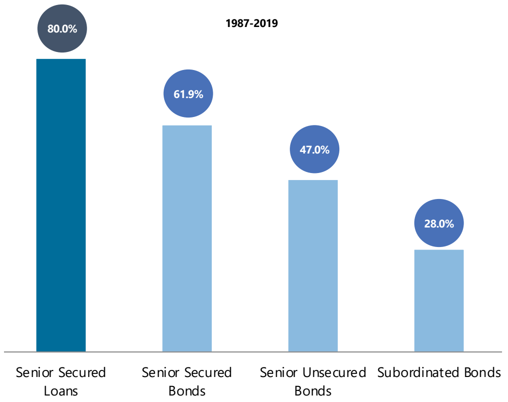
We know though, that in credit (loans and bonds) even where there is a default, there is a recovery value; i.e. debt investors generally see some level of return post a default. Applying historical recovery rates to the portfolio mix of each LIT, we calculate that the traded unit prices continue to overestimate the extent of potential loss.

History of loan defaults – US loan default rate[1]



[1]S&P LSTA LLI/ELLI Default Rates July 30, 2020. LTM $ of Defaults/Total Outstanding. Source: ASX, Morgans Research, Company Reports

Credit instruments – history of recoveries[1]



[1]Moody's Annual Default Rate Study (released February 2020). Average recovery rates measured by ultimate recoveries. For illustrative purposes only. Source: ASX, Morgans Research, Company Reports.

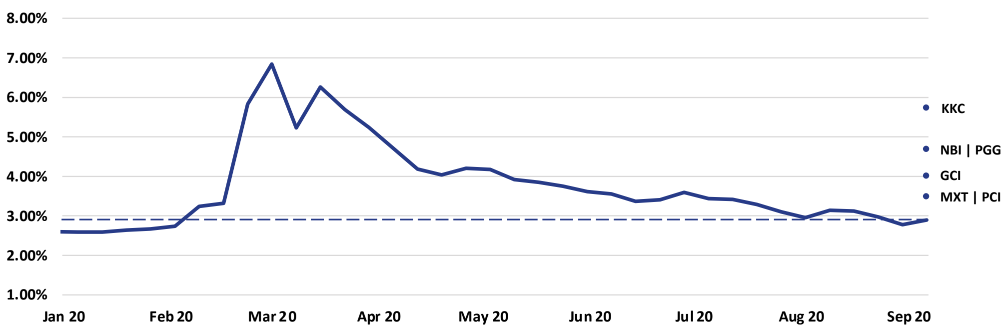
The move up in unit prices we see as a two-stage process; firstly ASX unit prices should continue to move back towards NTA. Secondly, as credit markets continue to improve, we should expect NTAs to continue to move back toward each LIT's issue price. This means that LITs look cheap and represent excellent value.

What about the yield?

All LITs continue to meet their distribution targets. This is in stark contrast to ordinary equity dividends where many companies have reduced or even deferred dividend payments. The bank regulator APRA has directed banks as to how they consider dividend payments. These directions have not applied to bank hybrid distributions though and might explain the substantial rally in hybrid prices back to near pre-COVID-19 levels.

The chart below shows the move in bank hybrid spreads against the current yield levels available from ASX listed LITs. With the rally in hybrids and equity dividends uncertain, investors looking for regular income should refocus on the LIT sector with attractive pricing and yields.

Trading margins on major bank AT1 listed instruments



Trading margins as of 25 September 2020. LIT target cash running yields as of 25 September 2020. Source: ASX, Morgans Research, Company Reports.

Consumer discretionary – all set for a merry Christmas

The retail reporting season was resoundingly positive, benefiting from various government stimulus packages and, more importantly, a major redirection of discretionary spend following peak COVID-19 for well-known reasons.

We think robust sales trends will persist while COVID-19 remains a threat to communities (at least 1H21). Inadvertently, the development of a vaccine potentially poses a valuation threat to the sector (ability to redirect spend) just as much as the potential dampening sales impact from the tapering of stimulus/weaker economy.

Anything to do with the home (electronics, homewares, furniture, fitting) have been the best performing categories and this has the potential to continue over the balance of 1H21. As the cyber/Christmas events roll around, we expect pockets of strength in fashion, accessories and outdoor/leisure categories to emerge – providing infection rates/restrictions don't intensify.

The combined power of strong year-end trading and cushioning impact of JobKeeper (which allowed companies to stand up more staff than perhaps they otherwise would have) has seen liquidity positions improve. Liquidity is no longer a hot topic for the sector. No matter how investors think about over-heated/pulled-forward sales and JobKeeper benefits, the cash impact was real and the enduring impact is manifested in materially enhanced balance sheets.

After years of FX headwinds resulting from a falling AUD/USD, the recent strength of the AUD provides meaningful reprieve in terms of less pressure on COGS (benefiting gross margins) – main benefit in 2H21.

We think the upcoming November cyber events will be significant this year, more so than ever before, as consumers consider delivery lead times for Christmas, have the time/ability to plan further ahead this year and a far more receptive attitude to online consumption. After a tough year, we think Australians will spend up on their families this Christmas.

We maintain a constructive position towards the sector given our view that robust growth will continue over the balance of 1H21 at least. However, we can already see evidence of the market starting to consider the strength some of these beneficiaries will have to cycle in 4Q21 and 1H22 and we are mindful of this.

Key picks after a strong sector rally: **Adairs**, **Eagers Automotive**, **Breville Group** and **Super Retail Group**. Baby Bunting is possibly the best placed retailer we cover in terms of growth and market position, but after a strong rally we would prefer to buy on weakness. We are prepared to be patient with Lovisa short-term as a second phase recovery stock (when it turns, it will be quick).

For more see our latest note Retail stock-take: Reporting Season Wrap published 3 September 2020.

Industrials – fairly resilient

The sector as a whole performed reasonably well during the August reporting season with the majority of stocks in our coverage universe delivering results that were either in line or above expectations. Not surprisingly, the key swing factor was the impact of COVID-19 on the individual businesses. Some were forced to temporarily close their operations due to government-imposed restrictions while others were able to operate with minimal disruptions.

Importantly, all the companies we cover maintained healthy balance sheets or in the case of InvoCare and Reece, pre-emptively raised equity near the start of the pandemic in Australia to help them navigate through the uncertain outlook. With ongoing risk of COVID-19 outbreaks and further economic restrictions, maintaining a strong financial position remains as important as ever.

Essential-service providers such as packaging company Amcor and pallet-pooler Brambles delivered very resilient results and were part of only a handful of companies that provided quantitative earnings guidance for the year ahead. This should provide comfort for investors in a market that remains clouded. Amcor remains our key pick in the large caps space given its highly defensive business model and experienced management team.

At the smaller end of the market we continue to like **PWR Holdings** and **Acrow**. PWR will benefit from the restart of the motorsports season with the deferral of races providing a significant boost to FY21 earnings. Acrow continues to be leveraged to increased civil infrastructure activity over the longer term with positive catalysts from further meaningful contract wins.

We note that a higher AUD will be a headwind for stocks with meaningful exposure to international markets such as Amcor, Orora, Brambles, Reece, Reliance Worldwide Corp and PWR Holdings.

Recent publications

Amcor
ADD TP $17.10
Very dependable

PWR Holdings
ADD TP $5.10
Back in business

Acrow
ADD TP $0.40
Making the right moves

Property – segments of compelling opportunities

The sector outperformed the broader market over the past quarter which included the recent reporting season updates. On outlook, most REITs with long lease expiries and/or exposure to funds management provided guidance with most unwilling to give guidance with COVID-19 uncertainty remaining. Overall, most REITs are expected to keep distributions relatively flat or slightly below FY20 levels. For some groups we flag ongoing near term earnings and distribution volatility until there is further clarity on the final outcome of Code of Conduct and rental negotiations in general (particularly given the extended lockdown in VIC).

Over reporting season industrial assets proved resilient and highlighted the increasing acceleration of online retail/logistics. Office REITs continue to be impacted by the work from home thematic however June valuations were stable overall despite many office exposed REITs trading at discounts to NTA. REITs exposed to residential housing saw better than expected results supported by government stimulus. As expected REITs exposed to traditional retail continue to face headwinds and longer-term structural challenges which was reflected in lower June valuations. However we note that large format/convenience retail exposures remain well positioned with daily needs (eg supermarkets) and in home spend strong.

Sector balance sheets and liquidity remain sound with most REITs (ex mall retailers) raising for acquisitions vs any covenant concerns. In general, debt remains diversified across lenders with debt expiries spread out and interest coverage ratios well above covenants. Some groups have also drawn down on existing facilities, cut distributions, pulled back on development pipelines or stopped buy-backs to ensure maximum liquidity available. Most REITs have gearing between 30-40%.

Near term unknowns and risks include: 1) FY21 earnings/distribution impacts from Code of Conduct outcomes/lockdowns; 2) how COVID-19 will impact valuations (transactions significantly lower so likely impact will be around income/increased vacancy, etc); 3) the general economic environment post lockdown; and 4) impacts on leasing/rental market/tenant quality.

Our preferred REITs under coverage are:

- **Specialised** - Waypoint REIT, APN Convenience Retail REIT (service station assets)
- **Diversified** - APN Industrial REIT (industrial/business parks)
- **Office** - Centuria Office REIT (metro office assets)
- **Retail** - Aventus – (large format retail centres) and HomeCo (HMC) – (focus on daily needs + health/wellness assets)
- **Industrial** - Centuria Industrial REIT (pure play Australian industrial assets)

Recent initiations

TPG Telecom – ADD **PT A$8.71**	TPG is Australia's #3 full-service telecommunications provider. It serves the price conscious end of the market. The key brands are Vodafone for mobile and TPG, iinet and Internode for fixed line. TPG has ~22% of the market by subscribers.
Breville Group – ADD **PT A$27.46**	BRG is a global player in the design, development and distribution of consumer appliances. It operates mainly across the Breville, Sage, and Kambrook brands over 3 key market segments: beverage; cooking; and food preparation.
Alliance Aviation Services – ADD **PT A$4.00**	AQZ is a leading provider of contracted and ad hoc charter services to Australia's mining, energy, tourism and government sectors.
Medlab Clinical – SPECULATIVE BUY **PT A$0.32**	MDC is an Australian listed healthcare company with assets in the nutraceutical, pharmacological, and drug delivery space.
PTB Group – ADD **PT A$0.86**	PTB provides Maintenance, Repair and Overhaul (MRO) services for narrow body aircraft, aircraft and engine leasing, as well as the sale of spare parts.

Source: Morgans, Bloomberg

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.

This month we add **QBE, Magellan Financial, Nufarm, Volpara, Catapult Group** and **Mach7 Technologies.**

Refer to our **Updated Best Ideas** for more **www.morgans.com.au/stockpicks**

Company	Sector	Size	Risk	Price	12m price target	Dividend yield	Gross yield	12m TSR
Aristocrat Leisure (ALL)	Consumer Discretionary	Large	Moderate	$30.74	$31.31	1.50%	1.50%	3%
Coles Group (COL)	Consumer Staples	Large	Lower	$17.43	$18.90	3.60%	5.20%	12%
Santos (STO)	Energy	Large	Moderate	$5.06	$6.25	2.00%	2.00%	25%
Woodside Petroleum (WPL)	Energy	Large	Moderate	$18.00	$23.40	3.20%	4.60%	33%
Macquarie Group (MQG)	Financials	Large	Moderate	$123.40	$130.41	3.40%	4.00%	9%
QBE Insurance (QBE)	Financials	Large	Moderate	$8.95	$12.07	5.10%	6.40%	40%
Westpac (WBC)	Financials	Large	Lower	$17.41	$22.50	5.70%	8.20%	35%
Aurizon Holdings (AZJ)	Industrials	Large	Lower	$4.29	$5.14	6.20%	8.10%	26%
Amcor (AMC)	Materials	Large	Lower	$15.39	$17.10	4.20%	4.20%	15%
Rio Tinto (RIO)	Materials	Large	Moderate	$96.02	$107.00	5.60%	8.00%	17%
BHP Group (BHP)	Materials	Large	Moderate	$36.28	$37.60	3.30%	4.70%	7%
Sydney Airport (SYD)	Industrials	Large	Moderate	$5.99	$6.56	0.00%	0.00%	10%
APA Group (APA)	Utilities	Large	Lower	$10.57	$10.45	4.80%	5.50%	4%
TPG Telecom Ltd (TPG)	Communication Services	Mid	Moderate	$7.48	$8.71	1.50%	2.20%	18%
Coca-Cola Amatil (CCL)	Consumer Staples	Mid	Moderate	$9.59	$10.39	4.30%	4.80%	13%
Beach Energy (BPT)	Energy	Mid	Higher	$1.36	$2.06	1.50%	2.10%	53%
Magellan Financial (MFG)	Financials	Mid	Moderate	$58.98	$61.05	3.90%	5.20%	7%
ResMed Inc (RMD)	Health Care	Mid	Moderate	$23.60	$29.33	1.00%	1.00%	25%
ALS Limited (ALQ)	Industrials	Mid	Moderate	$9.30	$9.00	1.50%	1.70%	-2%
NEXTDC (NXT)	Information Technology	Mid	Moderate	$12.29	$13.89	0.00%	-	13%
Incitec Pivot (IPL)	Materials	Mid	Moderate	$2.06	$2.35	3.00%	3.60%	17%
Super Retail Group (SUL)	Consumer Discretionary	Small	Moderate	$11.24	$11.53	4.30%	6.10%	7%
Adairs (ADH)	Consumer Discretionary	Small	Moderate	$3.69	$3.80	0.00%	-	3%
Corporate Travel (CTD)	Consumer Discretionary	Small	Moderate	$17.32	$14.20	0.00%	-	-18%
Eagers Automotive (APE)	Consumer Discretionary	Small	Moderate	$10.59	$9.99	3.50%	5.00%	-2%
Redbubble (RBL)	Consumer Discretionary	Small	Higher	$4.22	$4.33	0.00%	-	3%
Breville Group (BRG)	Consumer Discretionary	Small	Moderate	$26.51	$27.46	0.00%	-	4%
Costa Group Holdings (CGC)	Consumer Staples	Small	Higher	$3.56	$3.70	2.70%	3.90%	7%
Senex Energy (SXY)	Energy	Small	Higher	$0.32	$0.48	0.00%	-	50%
Karoon Energy (KAR)	Energy	Small	Higher	$0.80	$1.56	0.00%	-	96%
Generation Development (GDG)	Financials	Small	Moderate	$0.74	$0.94	2.70%	2.70%	29%
Zip Co (Z1P)	Financials	Small	Higher	$6.96	$10.28	0.00%	-	48%
Kina Securities (KSL)	Financials	Small	Higher	$0.79	$1.41	15.20%	15.20%	94%
Volpara (VHT)	Health Care	Small	Higher	$1.37	$1.73	0.00%	-	26%
Mach7 Technologies (M7T)	Health Care	Small	Higher	$1.13	$1.49	0.00%	-	31%
Acrow (ACF)	Industrials	Small	Higher	$0.37	$0.40	5.00%	7.20%	13%
PWR Holdings Limited (PWH)	Industrials	Small	Moderate	$4.65	$5.10	2.20%	3.20%	12%
People Infrastructure (PPE)	Industrials	Small	Moderate	$3.09	$3.30	3.60%	5.20%	10%
Alliance Aviation Services (AQZ)	Industrials	Small	Moderate	$3.41	$4.00	3.20%	4.50%	21%
Catapult Group (CAT)	Information Technology	Small	Moderate	$2.06	$2.44	0.00%	-	19%
Nufarm (NUF)	Materials	Small	Moderate	$3.91	$5.10	0.00%	-	30%
Orocobre (ORE)	Materials	Small	Higher	$2.78	$3.36	0.00%	-	21%
APN Conv. Retail REIT (AQR)	Real Estate	Small	Lower	$3.80	$3.92	5.80%	5.80%	8%
Aventus Group (AVN)	Real Estate	Small	Moderate	$2.38	$2.62	6.10%	6.10%	16%
Waypoint REIT (WPR)	Real Estate	Small	Lower	$2.78	$2.81	5.70%	5.70%	7%

Source: Morgans. Data as at 7th October 2020.

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Recommendation structure

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