Holiday Edition 2015

# Investment Watch

## Charting a course for 2016

2015 started off strongly, the S&P/ASX 200 rose quickly on another RBA interest rate cut and the European Central Bank (ECB) deploying their long awaited quantitative easing (QE) program, the index closed a touch under 6,000 in April; however, investor sentiment turned quickly as the debt negotiation in Greece, slowdown and uncertainty of Chinese growth and the increasing expectations of an increase in the US Fed Funds rate halted the rally. Since then the market has traded in fits and starts. **While volatility has yet to be fully contained, we think the fundamentals in place for 2016 will support the equity market.**

We think the market will eventually adjust to the initial shock of the first US official interest rate rise, particularly if the trajectory and pace is clearly communicated. Further, if expectations of another domestic rate cut (Page 2) and conditions for a turnaround in company earnings can be sustained, then we think the market will find support. While hopeful, we remain mindful that many of the concerns that plagued investors in 2015 will not go away quietly. And we remind investors not to be complacent. Several key issues will command our attention over coming months:

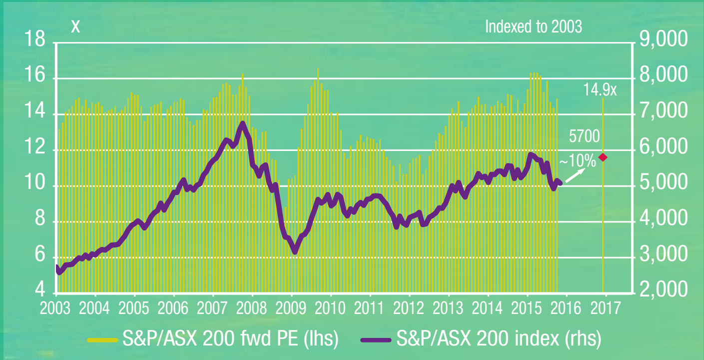
- China's ability to manage its current growth trajectory away from fixed asset investment
- The pricing of traditional growth bellwethers oil, copper and aluminium remains under pressure
- Earnings expectations for Australian companies remain weak, and
- Sentiment remains fragile and concerns around the housing market may temper investor appetite for risk.

Solid returns are still achievable in this market; however, these should not come at the expense of investors taking on excessive levels of risk.

**We suggest investors consider the following:**

- **Beware of complacent investing**: Understand the headwinds against the traditional market stalwarts among banks, staples and resources.
- **Follow strong conviction themes and stocks**: Strong returns are achievable in Australian stocks, albeit in less traditional stocks and sectors.
- **Diversify internationally**: Capture compelling growth dynamics not available to domestic only investors.
- **Brace for higher levels of volatility**: Hold relatively higher levels of cash and regularly monitor portfolio exposure.

**S&P/ASX 200 potential capital upside using market earnings estimates**



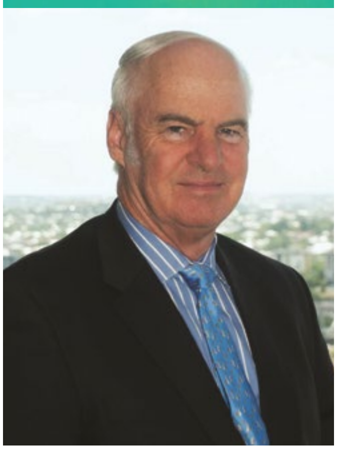

Sources: Factset, Morgans

# Contents

This holiday edition we look at ...



Visit our website to watch our Chief Economist, Michael Knox discuss his views on the Australian, U.S. and Chinese markets.



# Economic update

## US – Stronger growth in 2016 should generate an improving outlook for US earnings

We think the US economy will accelerate significantly in 2016 to reach a growth rate of 2.9% because of an acceleration in investment. The US has used up all of the excess resources left over from the GFC. Unemployment, which peaked at over 10% in 2009, has been steadily falling year on year. It is already 5% at the end of 2015.

This level is normally associated with the 'natural rate' of unemployment. As US unemployment continues to fall below this level, labour becomes increasingly scarce which means that wages growth starts to rise at a faster rate than inflation. Rising real wages then puts upward pressure on core inflation.

In 2016 we think investment in US manufacturing will be significant. This is not building new factories but rather re-equipping and re-tooling existing plants to make them more efficient and productive.

One of the interesting areas of new investment is the healthcare sector which has been one of the better performing parts of the economy. This sector needs more capacity as well. This means building more hospitals and healthcare centres. We think that commercial and healthcare construction should rise by around 9% in 2016.

While we have this recovery in non-residential construction, we will also have a continued recovery in US residential construction. We estimate that residential fixed investment will rise by around 11% in 2016. This combination of non-residential and residential construction, together with re-equipping factories and offices, supports a full-year growth rate of 2.9%. We think growth in investment in residential and non-residential structures will likely continue and support further growth into 2017.

## Australia – steady but unspectacular

The Australian economy is making a steady but unspectacular recovery. We think quarterly GDP in both Q3 and Q4 of 2015 will see an addition of 0.7%. This allows growth to accelerate from 2.2% in the middle of 2015 to 2.4% by the end of 2015 because residential investment is rising to take up the slack of declining non-residential construction. Non-residential construction is in decline as we move away from building new mines and mining infrastructure facilities.

Continuing growth of around 0.7% per quarter means that by the end of 2016, we estimate that growth will have accelerated to 2.8% which is around the 2.75% potential growth rate of the Australian economy. The result will be that unemployment will gradually begin to decline. Still, this is a very slow recovery compared to previous expansions in Australia. Unemployment will be maintained above the natural rate of unemployment which we think is around 5.4%. This means that wage growth will remain very low putting downward pressure on core inflation.

Both of these measures of core inflation increased by only 0.3% in the September quarter. Multiply that 0.3% by four and annualised core inflation is running at only 1.2%. That is half the RBA target and should it remain at this level in the December quarter, then it is extremely likely that the RBA will cut interest rates when it meets again in the first week of February.

### Australian Economic Forecasts End of 2016

| | Morgans Forecasts | Market Consensus |
|---|---|---|
| GDP Growth | 2.8% | 2.6% |
| Inflation | 2.5% | 2.4% |
| RBA Cash Rate | 1.75% | 1.75% |
| Aussie Dollar | 0.71 | 0.69 |
| ASX 200 | 5700pts | 5640pts |

Source: Morgans, Bloomberg

We may be looking at a more optimistic start for Australian equities in 2016

**The next move in interest rates is still most likely to be down.**

## A positive outlook for the equity market

Quarterly operating earnings per share for companies in the S&P500 continue to disappoint. Up until very late in the earnings season for Q3 2015, it still appeared that earnings would rise in Q3 2015 over Q2 2015. Unfortunately, announcements of energy companies and mining companies led operating earnings to decline to US$25.44 per share for Q3. We expect a recovery to US$29.32 in Q4. Still, this means that we may be well into the middle of 2016 before better earnings provide more fundamental support for further upside in the US equities market.

As we close the year, the outlook for the Australian ASX200 has become moderately more optimistic. Fair value for the ASX200 now stands at 5,493 up slightly from the number we gave you previously. This means that as we close the year, the Australian equities market is around 200 points too cheap. The market usually rises to fair value early in the new year. We may be looking at a more optimistic start for Australian equities in 2016.

# Equity strategy

## Investment strategy – Stay vigilant heading into 2016

The festive season is usually kind to equities. For the past 25 years, December has recorded the best monthly returns for both Australian and US equities at around a 2% average gain. Furthermore, both markets have recorded gains in December more than 75% of the time over this period. The theory goes that lighter market volumes (due to market participants taking holidays) restricts the supply of equities for sale, making it easier for buyers to push up prices.

However, this coming summer shapes as a critical time for investors to remain vigilant.

## Watching the US Fed

In mid-December (the 15th and 16th) the US Federal Reserve is expected to raise US cash rates for the first time in seven years. This would signal the beginning of the most significant shift in monetary policy that markets have had to digest since the Global Financial Crisis (GFC). Bond, currency and equity markets have flinched at this possibility several times now, triggering volatility across asset classes. There is an argument to say that, now more than ever before, markets are prepared for rates to rise; however, significant re-organisation of global capital could easily be triggered. We believe the balance of risk points to the potential for a short-lived shock to markets, before robust US economic fundamentals reassert themselves in early 2016.

## Market confidence is fragile

Fickle market trade through 2015 has been characterised by large swings in pricing based on relatively small changes in underlying fundamentals. This implies that investor confidence is poor and potentially vulnerable to unexpected changes in the macro-economic environment. The recent escalation of geo-political tensions in the Middle East amplifies this situation for investors, with many pointing to the unpredictable nature of Russia as the most concerning unknown in the equation. Remember that market uncertainty can significantly alter the pricing of risk.

## Sluggish Australian corporate earnings

The August corporate reporting season was patchy at best and concerning at worst, and resulted in downgraded earnings expectations across the market. Company outlook statements were more cautious than we have seen in the last few periods with caveats of 'uncertainty' in the economic outlook and reports of 'challenging conditions' dominating. Earnings guidance was in many cases below market expectations, or less committal than usual. Since then we've witnessed a broad erosion of earnings growth expectations across most sectors, punctuated by some concerning downgrades and capital raisings among some of Australia's largest corporates. This includes stalwarts like the major banks, BHP Billiton, Woolworths and Origin, many of which we expect to remain under pressure in 2016.

## What does it mean for 2016?

Australian shares are now trading only modestly below our estimates of fair value; however, our cautious stance through 2015 has been vindicated by the disappointing performance in the overall market year-to-date. While the yield differential between bonds and equities still favours equities, we are cognisant of the potential for the risks above to trigger ongoing volatility. We think that such unprecedented times require investors to take a more flexible approach in 2016 and that several tactical considerations are worth noting in this environment.

- **Moderate expectations of equity returns**: The gradual removal of US monetary stimulus is a natural headwind for equities.
- **Beware of complacent investing**: Understand the headwinds against the traditional market stalwarts among banks, staples and resources.
- **Follow conviction themes and stocks**: Strong returns are achievable in Australian stocks, albeit in less traditional stocks and sectors.
- **Diversify internationally:** Capture relatively compelling growth dynamics and currency tailwinds offshore.
- **Brace for higher levels of volatility**: Hold higher levels of cash and constantly monitor portfolio exposure.

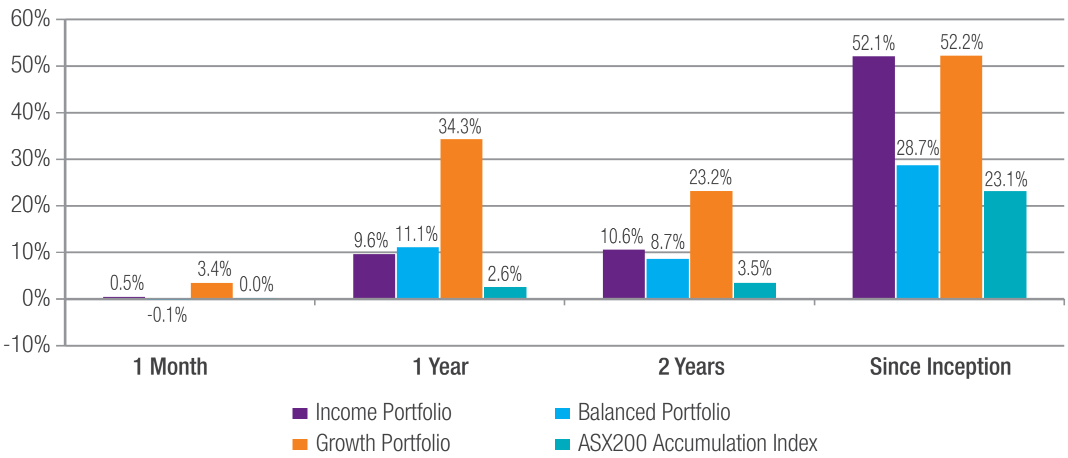
Strong returns are still achievable in this market, as we detail in our discussion around our key Research Products below; however, these should not come at the expense of investors taking on excessive levels of risk.

## Performance of strategy products

The Morgans research team and the Morgans investment committee produce two flagship products that contain our best equity ideas.

- **The High Conviction Lists** (updated monthly) detail those stocks we think offer the highest risk-adjusted returns over a 12-month timeframe, supported by a high level of confidence. We're pleased to report that in the last 12 months the average 'High Conviction Pick' has generated a 13% total return

**Morgans Model Portfolio Performance**




Source: IRESS, Morgans

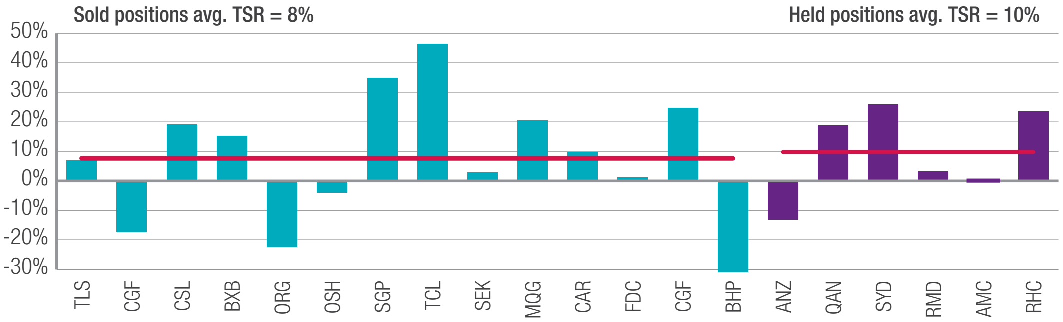
# Equity strategy continued

### From page 3

in less than six months. Strong Buy ideas in the current lists include ANZ Bank, Sydney Airport, ResMed, Amcor and Ramsay Health care. See page 10 for more detail.

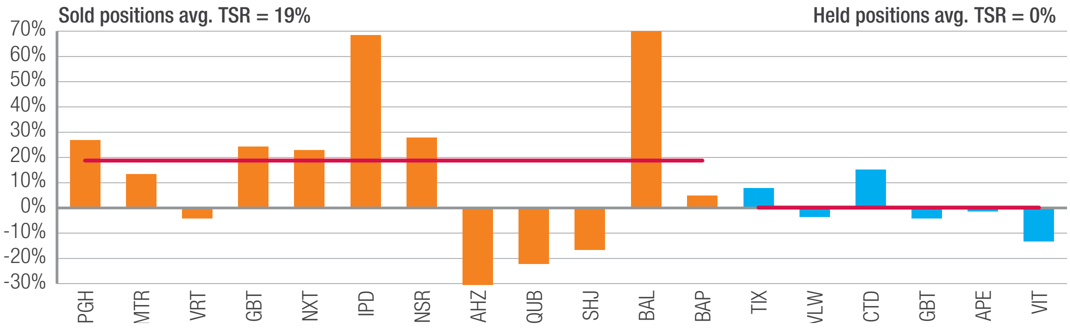
- **The Equity Model Portfolios** (also updated monthly) combine individual stock selection (often High Conviction ideas) to build the most appropriately constructed portfolios matched to income, balanced and growth investing styles. Via these portfolios we are also pleased to demonstrate meaningful 12-month total returns ranging from 9.6%-34.3% versus the market, which grew at 2.6% (including dividends) in what has been a very difficult 12 months for investors. See our website or contact your adviser for more detail.

### ASX100 High Conviction stocks 12 month performance




Source: IRESS, Morgans

### Ex-ASX100 High Conviction stocks 12 month performance




Source: IRESS, Morgans

# Banks – ANZ remains our key pick

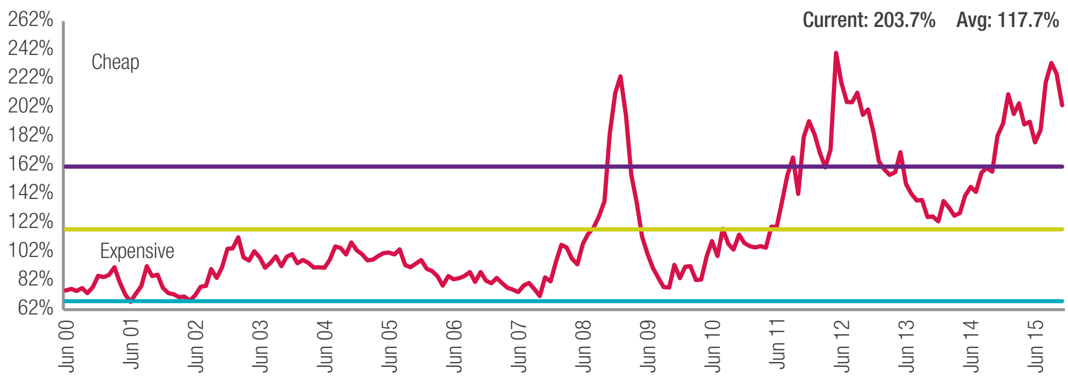
In a lower-for-longer interest rate environment, the global search for yield will support the elevated valuations and the security of the big four banks. The average dividend yield across the sector remains above 6%, a significant premium to benchmark bond yields of 2.8%. However, we see their operating environment as increasingly challenged in the near term and growth being hindered by a tepid economy and a potential slowdown in the mortgage market. There is also clear evidence of margin pressure, particularly in institutional banking, where global liquidity and rising competition are impacting profitability. This margin pressure may be ongoing given benefits of lower funding cost appear at an end and back book asset re-pricing looks set to continue. Cost cutting and productivity improvements again remain top of the priority list in 2016.

Against this backdrop, the banks are also seeing returns being impacted by significantly higher capital levels imposed by the regulator. The banks have raised over A$20bn of common equity capital over the past year. There may also be further capital top ups required post the Australian Prudential Regulation Authority's forthcoming capital review and global Basel 4 recommendations to be released in 2016. As returns fall, we expect current dividend payout ratios may prove increasingly unsustainable, particularly if there is a sharp increase in the bad debt cycle.

Despite recovering from its September low, we think the sector is now closer to fair value; **only ANZ looks genuinely cheap to us.** In an environment where we think dividend payout ratios will likely come under pressure over the next two to three years, we would prefer to top-up in the banks around any weakness around future capital raisings expected though 2016.

Refer to our website for the latest ANZ report published 20 September 2015.

### Banks dividend yield relative to bond yields




Source: Bloomberg

# Retail – expecting some extra Christmas cheer this year

The crucial Christmas trading period is upon us and it will, once again, be a critical litmus test for how the average consumer is faring. The Christmas period is pivotal for most discretionary retailers who typically earn a large portion of their earnings during this period.

With the AGM season behind us, it is clear to us that retailers in general are enjoying better trading conditions than they have for some time. Recent sales updates from Myer, Kathmandu, Super Retail Group, Harvey Norman, Domino's Pizza, David Jones and Burson Group were all positive. Outlook commentary was also more optimistic than it has been for some time.

We expect the consumer staples sector to remain challenged in 2016 as Woolworths, Wesfarmers, Metcash and Aldi all fight for increased market share. The winner will no doubt be the consumer as each operator tries to compete hard on price while improving the fresh offerings and customer service. We continue to believe Wesfarmers is the best way to play this space in 2016 given the strong performance of all its key retail businesses throughout 2015. 2016 is a critical year for Woolworths with a new CEO joining the company and some important strategic decisions to be made. While Woolworths appears cheap, we think investors should wait for more clarity on the strategy before proceeding.

A recent lift in consumer sentiment (now at a near two-year high) and a still-buoyant housing market are driving the improved trading conditions. This is in spite of price inflation driven by the lower AUD as retailers pass through the inflationary impact on their cost of goods sold to consumers. We continue to watch the housing market closely for any signs of a real pull-back, but expect

reasonably solid conditions will continue for some time yet.

Overall, we expect a solid Christmas trading period for the retailers across the board. However, we also remain stock pickers in this sector, favouring stocks with a strong competitive advantage, multiple earnings growth drivers and with catalysts present.

In consumer discretionary, our key picks include: **RCG Corporation (RCG), Domino's Pizza (DMP)** and **Baby Bunting (BBN).**

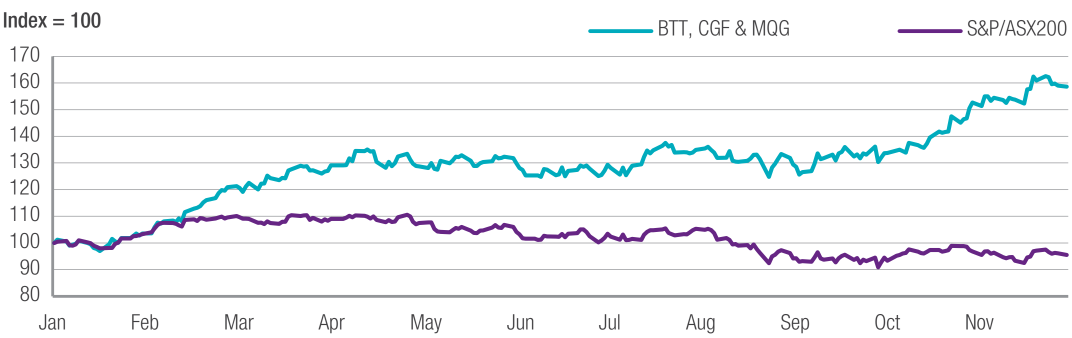
# Diversified financials – sticking with momentum

2015 capped another very strong year for the diversified financials sector, with the average total shareholder return for the sector of just over 30%. Within the sector our key picks and dominant model portfolio holdings delivered positively for shareholders, namely **Macquarie Group** (MQG: 45% return); **BT Investment Management** (BTT: around 40% return since May); and **Challenger** (CGF: 37% return). Whilst we are pleased to report this performance, as always the key question remains the outlook for the year ahead. On this front, we are reluctant to change our stock preferences at this point given the structural tailwinds that support most investment cases. However, we are treading much more carefully around valuations and therefore on entry points into our preferred stocks (ie, we suggest using market volatility to add any further exposure).

To recap quickly, we continue to like the following stocks:

- **Challenger**'s macro picture remains strong with demand for annuities supported by low interest rates (for some time to come) and a structural demographic shift of superannuation funds to retirement income.
- **BT Investment Management** is structurally growing its funds management presence in the US market, the largest market globally for equities under management. In our view, there is plenty of growth to come for BTT in the US irrespective of short-term market moves.
- **Macquarie Group**'s strong exposure to offshore markets and leverage from a weakening Australian dollar continues to assist earnings. Recent acquisitions highlight the group's ability to make accretive acquisitions, which is likely to remain a feature of the business over the medium term.

**2015 Performance of CGF, BTT, MQG – vs S&P/ASX200**



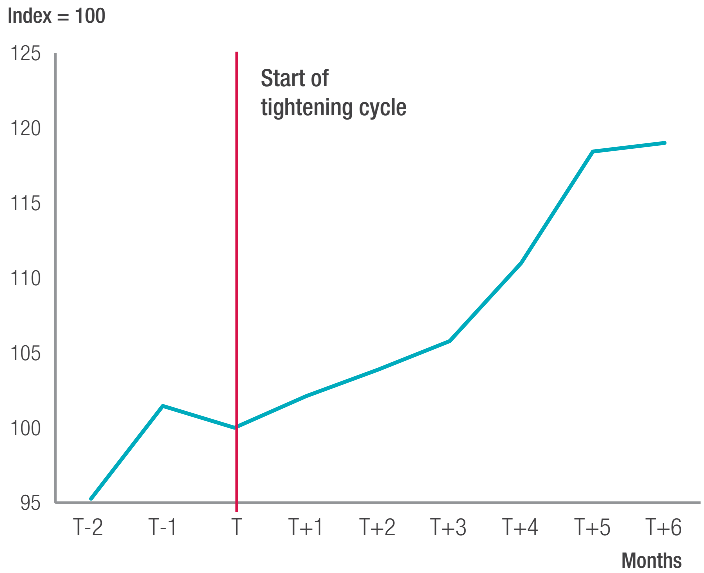

Source: IRESS

# Insurance – looking towards the US Fed decision for QBE

The insurance sector overall has been relatively stable in the last quarter. QBE has pulled back slightly after the company confirmed FY15 guidance towards the bottom end of its previous target range. We think the market was probably expecting a better year-end result than this and was also a little concerned with QBE commentary that insurance pricing remains tough. **We continue to maintain our Add rating on QBE and believe it will re-rate closer to A$14.00 when the US Federal Reserve lifts interest rates in the not-too-distant future.**

For IAG and Suncorp (SUN), we expect 1H16 is tracking well and both stocks appear on track for a good result given favourable weather. If weather remains favourable into December, both share prices should start to push up early in the new year as the market factors this in. The Reserve Bank of Australia's (RBA) decision to keep interest rates on hold is also a positive for IAG and SUN given significant Australian dollar bond holdings. On AMP, while the company pointed to some rise in life insurance claims in the third quarter, these remain inside management assumptions. We do not see any large risk as this stage for AMP's FY15 result, but feel it will only re-rate further in the near term on a lift in equity markets, which is hard to call.

**QBE performance over previous five US rate tightening cycles**




Source: Factset, Morgans

# Resources – a mixed outlook

It is a turbulent time for commodity prices, with a broad spectrum of macro and fundamental themes creating an environment of uncertainty that has impacted business and investor confidence alike. Commodities prices fell across the board towards the end of the year as China's slowing growth weighed on demand. Iron ore remains under pressure, with the world's largest suppliers ramping up production as well as significant new projects pushing iron ore into surplus. This, combined with resilient high-cost Chinese production and cooling demand conditions, leave us with a negative view on iron ore in the short term.

Gold prices rallied in October as a combination of economic uncertainty and uncertainty over the US Federal Reserve rates decision saw investors flock to the yellow metal. Since then the metal has weakened; however, we expect similar volatility heading into the December US Federal Reserve rates decision. We remain positive on Australian domestic gold producers as a result of a positive currency tailwind.

Coming out of resources companies AGM season, our key take-away was that whilst no-one professed to be able to pick where the metals prices might be in the near term, general consensus was that equities are cheap but the outlook for commodities prices, at least in the short term, remains opaque. Growth in the next 12 months will be largely dependent on successful rebalancing in China, a healthy US economy and the recovery of growth in developing countries, which would see demand for metals grow.

Visit our website for our latest report on BHP updating our commodities view and implications of the Samarco dam failure.

# Telstra – value starting to emerge

The telecommunications sector performed reasonably well again in the last quarter. While we retain our underweight recommendation, we think there are some selective opportunities. Last month, following Telstra's investor day, we upgraded our recommendation to an Add (from Hold; A$5.93 price target) on the view that:

- the share price is already factoring in the increased competition
- the shares are approaching fundamental support (at close to their long-term average PE ratio of 14x), and
- our expectations that Australian interest rates will track lower which should reignite support for the defensive yielders.

We also attended M2 Group's (MTU) investor day (Hold; A$9.77 price target) and Vocus' (VOC) (not rated), which are in the process of merging to form Australia's fourth largest telecommunications company (and an ASX100 stock). We have been supporters of MTU for a long time and while we do not yet have formal research on the combined group, we think the rationale for putting the two businesses together makes sense. Morgans recently hosted MTU's CEO, Mr Geoff Horth, who provided us with an update on the business and the rational for merging with VOC.

Visit the link below to hear the story first hand **https://youtu.be/iKaRwQ_-IjU**

# Energy – short-term volatility creates long-term opportunity

A mixed end to the year for energy, but for varying reasons we see little value on offer amongst the large-caps. The clear stand out performance has been Oilsearch (OSH), our preferred energy exposure, which has rallied 40% off its low in August although is now approaching fair value given our A$8.50 target price. Most disappointing has been Santos (STO), with management electing for mass dilution to avoid selling any assets at a discount. While we still see STO as undervalued, we think the move is value destructive and believe the upside beyond A$6.65 has been removed. In our view the A$6.88 per share Scepter cash offer would have been a better outcome for shareholders than the A$3bn issued in new equity. Woodside's (WPL) share price remains depressed with the probability of a revised offer for OSH still seeming reasonably high. We continue to like WPL as an operator but do view it as lacking near-term positive catalysts and recognise that any revised offer for OSH would see WPL's share price remain under pressure in the short term. **We still see value at the smaller end of the sector with most small and mid-cap energy producers and explorers under our coverage remaining at often significant discounts to value**, with persisting weakness in investor sentiment the result of continued volatility in oil prices (a factor we expect to moderate in 2016).

# Transport – a changing landscape in 2016

After a busy M&A period in 2015, the transport sector in 2016 will likely see the conclusion of the two proposed takeovers of Asciano and Recall. Qube will have to fight hard to win the battle for Asciano against Brookfield, but we expect it to emerge victorious given the synergies it can extract from putting the container terminals business together with its existing rail and intermodal hub business. We therefore continue to see a bright future for Qube and believe 2016 could be a transformational year for them as the Moorebank intermodal terminal begins development.

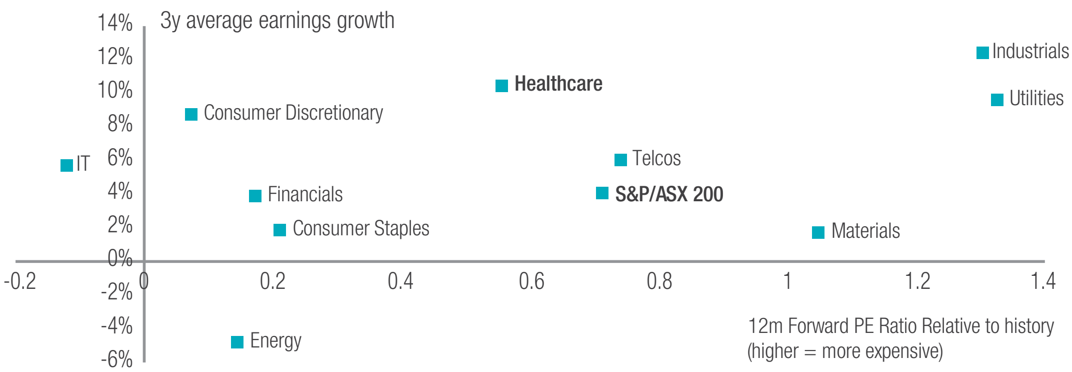
Across the rest of the sector, we expect airlines to continue performing well, with low oil prices keeping costs down while the revenue line benefits from a much more rational competitive environment. **We therefore see a lot more upside for Qantas ahead with earnings improving towards record levels.** Brambles remains a high quality defensive growth play, in our view, although will be reliant on improvement in its key US and European markets to see the stock re-rate higher from here.

# Healthcare – solid earnings outlook will underpin performance in 2016

The Healthcare Index continues its multi-year strong performance, up 17.8% over the past 12 months compared with the ASX 200, which returned -1.1% over the period. The outperformance was driven largely by offshore earners CSL, ResMed (RMD), Ramsay (RHC), Cochlear (COH) and Sonic (SHL). Looking into 2016, we expect the broader market to remain choppy and volatile and advise clients to position portfolios for both capital preservation and for growth. Thus, we view proper allocation healthcare as a must as the sector's defensive-structural growth, underpinned by an aging population, further medical innovation, and a continuing move by governments to outsource to the private sector, along with a weak Australian dollar, remain key sector tailwinds to support continued outperformance.

**We like Healthcare Services (RHC and HSO), followed by Medical Devices (RMD) and Pharmaceuticals (CSL).** We remain somewhat cautious around some domestically-exposed healthcare names (eg PRY, CAJ, VRT and MVF), given regulatory uncertainty around the ongoing government reviews, with an interim report expected before Christmas and final recommendation late 2016 or early 2017. Key trends include: telemedicine, eHealth, immuno-oncology (using own immune system to fight cancer), personalised medicine, governments pushing more toward user pay, biosimilars and political pressure on drug pricing. The top five emerging healthcare names with imminent catalysts include: Rhinomed (RNO); Neuren Pharmaceuticals (NEU); Admedus (AHX); Viralytics (VLA); and Impedimed (IPD). Near-term profitability stories include: IDT Australia (IDT); Universal Biosensors (UBI) and Cogstate (CGS).

**Sector comparison – healthcare earnings growth relative to valuation**




Source: Factset, Morgans

## Get ready …

### T+2 and changes to the ASX Settlement Cycle are fast approaching

- Settlement for Australian sharemarket trades will be shortened by one day (currently T+3)
- ASX proposed change expected to occur on Monday, 7 March 2016
- For further information regarding the change to T+2, speak to your Morgans adviser or download the ASX brochure at www.asx.com.au/T2Brochure

Tomorrow's blossoms rely on today's seeds

## Stay in touch with the market during your Christmas holiday

- **www.morgans.com.au** – breaking news, share prices and company research updates
- **www.morgans.com.au/blog** – stay up to date with our analysts and key picks via their personal blog posts
- **@morgansAU** – follow us on twitter for daily market updates
- **Linked in**

# Infrastructure and utilities – tracking along nicely

Over the past 12 months, stocks in the infrastructure space have produced another period of strong returns. Of the 11 stocks in the sector, all except DUET (DUE) and Spark Infrastructure (SKI) produced total returns at least in the high teens. The strongest performers have been airports (Sydney and Auckland), tollroads (Macquarie Atlas and Transurban), and takeover targets (Asciano and Energy Developments). The share prices of DUET and SKI were impacted by regulatory resets and capital raisings, but both still produced positive returns (while the broader market XJO declined across the period).

Also of note was the sector's defensive qualities. The XJO decreased in 17 of the last 36 months, while the median decline of stocks in the sector was 13 months across the period.

Drivers of returns included M&A activity, attractive yield, defensive earnings, growth, and asset quality. Increasing scarcity of stocks with such characteristics is also driving prices.

## Available soon – contact your adviser for your copy of:

- **Your Wealth** Issue 10 – available 18 December
- **Investment Strategy** 1st Quarter 2016 – out mid January 2016

# Technical corner

## S&P/ASX 200 (XJO)

The S&P/ASX 200 Index has been trading in a down trend since May 2015, which remains technically intact. The down trend has lost momentum over the past three months and the price has been trading sideways, fluctuating between 4918 and 5384. The shape of the consolidation is neutral and shows that a great deal of indecision prevails among market participant. The momentum indicators remain in a trading range and we favour further consolidation in the near term. In the short term, the recent rally appears to be losing momentum and we expect a decline to 4950 – 5000.


Source: IRESS

## Current Corporate Offers – December 2015

| | Absolute Equity Performance Fund | Jayex Healthcare Limited | Wellard Limited | Megaport Limited | Macquarie Group | IPH Limited |
|---|---|---|---|---|---|---|
| **Offer type** | Initial Public Offer | Initial Public Offer | Initial Public Offer | Initial Public Offer | Capital Notes Offer | Share Purchase Plan |
| **Offer size** | $100m | $8.0m | $300m | $25m | $500m | N/A |
| **Closing date** | 4 December 2015 | 4 December 2015 | 8 December 2015 | 8 December 2015 | 15 December 2015 | 16 December 2015 |
| **Listing date** | 16 December 2015 | 18 December 2015 | 10 December 2015 | 17 December 2015 | 21 December 2015 | 31 December 2015 |

# High Conviction Stocks

In the digital edition, you may click on the stock tables for links to the latest company research reports from our website. You can also watch our analysts outline key reasons to buy our recently added stocks in short videos available here **www.morgans.com.au/high-conviction-stocks-dec-15-jan-16**

## Top 100

## This month's changes

The market is pricing in a very high chance that the US Federal Reserve will lift official interest rates when members meet on the 15-16 December. We urge investors not to be complacent ahead of this, as volatility can quickly erode confidence. We suggest investors stick to stocks with higher levels of conviction and those that have shown resilience to a rising rate environment.

This month we have removed Challenger (CGF) and BHP Billiton (BHP) from our high conviction list.

### Amcor AMC

| | | | |
|---|---|---|---|
| Price | $13.48 | PE (x) | 16.5 |
| Price Target | $14.69 | Yield | 4.2% |
| Upside | 9.0% | Gross Yield | 4.2% |

Amcor is a global packager servicing defensive sectors such as food and beverage, healthcare, personal and homecare, and tobacco.

**Key reasons to buy**

- Its defensive characteristics are appealing in an uncertain environment. AMC generates 95% of revenue from sectors such as food and beverage, healthcare, personal care and tobacco packaging.
- A falling AUD has a positive impact on our AUD-based valuation and the translation of USD dividends.
- AMC is always a potential capital management candidate given strong free cash flow generation. It recently completed a US$500m buyback and we see potential for further capital management opportunities down the track.

### ANZ Banking Group ANZ

| | | | |
|---|---|---|---|
| Price | $27.81 | PE (x) | 11.2 |
| Price Target | $34.21 | Yield | 6.7% |
| Upside | 23.0% | Gross Yield | 9.6% |

ANZ is among the top 20 banks globally with the largest Asian exposure of the Aussie banks.

**Key reasons to buy**

- ANZ is the cheapest bank on every metric and is executing well domestically.
- ANZ has the largest currency exposure and has leverage to Asian lending where growth should comfortably exceed the anemic growth in domestic lending.
- Domestic high yield equities including the major banks should remain well supported with further interest rate cuts looking likely in Australia.

### Qantas QAN

| | | | |
|---|---|---|---|
| Price | $3.74 | PE (x) | 6.4 |
| Price Target | $4.65 | Yield | 8.0%* |
| Upside | 24.3% | Gross Yield | 8.0% |

Qantas is Australia's largest airline servicing both domestic and international as well as owning Australia's largest loyalty program.

**Key reasons to buy**

- The capacity growth outlook is the most favourable for some time providing increased revenue opportunities via increased load factors and ticket prices.
- Lower oil prices and a A$2bn internal cost-out program are providing a material earnings benefit, with QAN likely to sustain near record levels of profitability.
- News flow is a key share price driver with the next 6-12 months looking positive with monthly operating statistics and further capital management upside.

* distribution may be in the form of a dividend, cash-distribution or buy-back.

### Ramsay Healthcare RHC

| | | | |
|---|---|---|---|
| Price | $65.45 | PE (x) | 29.9 |
| Price Target | $73.11 | Yield | 1.8% |
| Upside | 11.7% | Gross Yield | 2.5% |

Ramsay is Australia's largest private hospital operator, and is expanding into the UK, France and parts of Asia.

**Key reasons to buy**

- Strong demand growth for medical services is driven by a global demographic shift.
- RHC has consistently delivered above-market earnings and dividend growth (last 17 years averaging 16.8% and 16.6% pa, respectively) and for the next three years, we forecast both metrics to grow c13% pa.
- RHC is expected to benefit from further public hospital outsourcing opportunities.

### Resmed RMD

| | | | |
|---|---|---|---|
| Price | $8.09 | PE (x) | 21.1 |
| Price Target | $8.86 | Yield | 2.1% |
| Upside | 9.5% | Gross Yield | 2.1% |

Resmed is a world leader in the development and manufacturing of medical products to treat sleep apnoea.

**Key reasons to buy**

- RMD controls c40% of the respiratory and sleep-disorder breathing market which is underpinned by a large and growing customer base, with favourable trends in obesity, aging, cardiovascular diseases and increasing diagnosis rates.
- Double-digit sales growth is underpinned by strong US flow generator uptake and continued strength in masks beating market growth rates.
- RMD is supported by structural growth, a weakening AUD, a strong net cash position and ample balance sheet capacity.

### Sydney Airport SYD

| | | | |
|---|---|---|---|
| Price | $6.38 | PE (x) | nm |
| Price Target | $6.75 | Yield | 4.7% |
| Upside | 5.9% | Gross Yield | 4.7% |

Sydney Airport is the 100% owner of a long-term leasehold of Kingsford Smith Airport, Australia's busiest airport.

**Key reasons to buy**

- SYD provides exposure to a premier infrastructure asset and prime retail space leveraged to Asian travel growth, as well as commercial property and parking.
- Interest costs are expected to fall materially, as out-of-the-money interest rate swaps expire and are replaced at far lower interest rates.
- The combination of solid earnings growth and falling interest costs should generate strong distribution growth and potential for capital management initiatives.

Source: IRESS, Morgans.
Priced at 3 December 2015.

# High Conviction Stocks

In the digital edition, you may click on the stock tables for links to the latest company research reports from our website. You can also watch our analysts outline key reasons to buy our recently added stocks in short videos available here **www.morgans.com.au/high-conviction-stocks-dec-15-jan-16**

## Ex 100

## This month's changes

We make no changes to the ex-ASX100 list this month.

| 360 Capital Industrial Fund TIX | | | |
|---|---|---|---|
| Price | $2.49 | PE (x) | 11.2 |
| Price Target | $2.69 | Yield | 8.6% |
| Upside | 8.0% | Gross Yield | 8.6% |

360 Capital Industrial Fund owns a portfolio of 21 industrial assets across Australia.

### Key reasons to buy

- TIX's underlying portfolio is solid with a good lease expiry profile (c5 years), attractive +9% distribution yield (paid quarterly) and the stock now trading at NTA.
- TIX has moved to a 93% holding in ANI post its recent revised bid.
- The next round of revaluations (December), potential index inclusion (March) and increased scale should all be positive for the group.

| AP Eagers APE | | | |
|---|---|---|---|
| Price | $11.02 | PE (x) | 20.4 |
| Price Target | $12.54 | Yield | 3.3% |
| Upside | 13.8% | Gross Yield | 4.7% |

AP Eagers operates a network of automotive dealerships across Eastern Australia.

### Key reasons to buy

- APE aims to double its share of the new car market from ~5% to 10%. Plenty of acquisition opportunities are available in a fragmented market.
- Higher margin used car sales are a key growth platform. APE aims to be an innovator/ disruptor of the established sales models, with the shopping centre concept expected to launch in early CY16, replicating the success of US peers.
- APE enjoys ample cashflow and balance sheet capacity. We see material earnings upside over the coming 12+ months.

| Corporate Travel Management CTD | | | |
|---|---|---|---|
| Price | $11.02 | PE (x) | 28.4 |
| Price Target | $13.20 | Yield | 1.9% |
| Upside | 19.8% | Gross Yield | 2.7% |

CTD provides innovative and cost effective solutions to the corporate travel market globally.

### Key reasons to buy

- CTD's market share is rising and new acquisitions are performing well. CTD is a key beneficiary of a falling AUD with about 50% of earnings now in USD.
- At its AGM, CTD reaffirmed it is tracking at the top end of its FY16 guidance for 30% EBITDA growth, which we think is conservative.
- Further acquisitions in North America and the ability to win more regional and global clients and cross selling opportunities between regions all offer additional upside.

| GBST GBT | | | |
|---|---|---|---|
| Price | $4.10 | PE (x) | 27.0 |
| Price Target | $4.97 | Yield | 2.6% |
| Upside | 21.2% | Gross Yield | 3.7% |

GBST is a provider of fund administration and financial markets systems growing in popularity with major institutions.

### Key reasons to buy

- GBST has an impressive recent track record of new contract wins with major global institutions.
- Prospects look good for some existing clients to upgrade from single to multiple applications.
- Despite heavy investment in new product development, the company generates high levels of free cash flow.

| Villa World VLW | | | |
|---|---|---|---|
| Price | $1.99 | PE (x) | 7.4 |
| Price Target | $2.83 | Yield | 8.3% |
| Upside | 42.3% | Gross Yield | 11.8% |

Villa World is an integrated residential land developer / builder delivering affordable housing across QLD and VIC.

### Key reasons to buy

- Of the small-cap developers VLW has the best placed portfolio (given its exposure to QLD) to capture continued strength in detached housing demand.
- VLW recently guided to ~6% growth in underlying earnings for FY16, which we think the group has a strong chance of outperforming.
- VLW's valuation is attractive at around a 7.5x PE; a slight discount to net tangible asset backing and delivering a ~8% fully franked dividend yield.

| Vitaco VIT | | | |
|---|---|---|---|
| Price | $2.77 | PE (x) | 28.9 |
| Price Target | $3.25 | Yield | 1.9% |
| Upside | 17.3% | Gross Yield | 2.7% |

Vitaco manufactures and distributes branded products within the nutrition, health and wellness industry.

### Key reasons to buy

- VIT's differentiator is its diversity across vitamins, sports nutrition and health foods, including manufacturing capacity and well known consumer brands.
- The group is targeting strong growth in exports via e-commerce channels, noting that China has 300m active online consumers.
- We like VIT's diversified portfolio/ brands, leverage to favourable dynamics and growth opportunities. Trading on an FY17F PEG of 0.6x, VIT looks attractively priced versus its peers Blackmores, Bellamy's and Freedom Foods.

Source: IRESS, Morgans.
Priced at 3 December 2015.

## Queensland

| | |
|---|---|
| Brisbane<br>Stockbroking, Corporate Advice, Wealth Management | +61 7 3334 4888 |
| Brisbane – Edward St | +61 7 3121 5677 |
| Brisbane – Tynan Partners | +61 7 3152 0600 |
| Bundaberg | +61 7 4153 1050 |
| Cairns | +61 7 4222 0555 |
| Caloundra | +61 7 5491 5422 |
| Emerald | +61 7 4988 2777 |
| Gladstone | +61 7 4972 8000 |
| Gold Coast | +61 7 5581 5777 |
| Ipswich/Springfield | +61 7 3202 3995 |
| Kedron | +61 7 3350 9000 |
| Mackay | +61 7 4957 3033 |
| Milton | +61 7 3114 8600 |
| Mt Gravatt | +61 7 3245 5466 |
| 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 |
| Yeppoon | +61 7 4939 3021 |

## New South Wales

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| Ballina | +61 2 6686 4144 |
| Balmain | +61 2 8755 3333 |
| Bowral | +61 2 4851 5515 |
| Chatswood | +61 2 8116 1700 |
| Coffs Harbour | +61 2 6651 5700 |
| Gosford | +61 2 4325 0884 |
| Hurstville | +61 2 9570 5755 |
| Merimbula | +61 2 6495 2869 |
| Neutral Bay | +61 2 8969 7500 |
| Newcastle | +61 2 4926 4044 |
| Newport | +61 2 9998 4200 |
| Orange | +61 2 6361 9166 |
| Port Macquarie | +61 2 6583 1735 |
| Scone | +61 2 6544 3144 |
| Sydney – Level 7 Currency House | +61 2 8216 5111 |
| Sydney – Level 9 | +61 2 8215 5000 |
| Sydney Hunter St | +61 2 9125 1788<br>+61 2 9615 4500 |
| Sydney Reynolds Equities | +61 2 9373 4452 |
| Wollongong | +61 2 4227 3022 |

## Victoria

| | |
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| Melbourne<br>Stockbroking, Corporate Advice, Wealth Management | +61 3 9947 4111 |
| Brighton | +61 3 9519 3555 |
| Camberwell | +61 3 9813 2945 |
| Domain | +61 3 9066 3200 |
| Farrer House | +61 3 8644 5488 |
| 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

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| Hobart | +61 3 6236 9000 |

## Western Australia

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| West Perth<br>Stockbroking, Corporate Advice, Wealth Management | +61 8 6160 8700 |
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