February 2016

Investment Watch

Managing heightened uncertainty

Attention turns this month from global factors to the domestic results season. Investors have had a lot to consider recently and increased trading volumes (2015 Q4 trading 7% higher than 2014 and 13% higher than 2013) indicate that a high degree of portfolio adjustment has occurred over a turbulent period.

As was the case for much of 2015, global concerns continue to weigh on the market, earnings have been deteriorating even beyond the resource sector and the current revenue growth outlook remains subdued. We do think this highly anticipated reporting season will provide an opportunity to assess the true picture of earnings and whether we are nearing a cyclical turning point.

Volatility will be a constant reminder this year that macro events can instantaneously steer the market from fear to euphoria.

Despite the market erasing a large chunk of returns achieved over the past two years, we do believe the operating environment remains favourable for equities. We see the potential for another rate cut, the Australian dollar sitting at a more supportive level for the economy, valuations reverted back toward long-run averages and a pro-business government agenda as positive market signals.

In this environment we do think some companies will manage the macro backdrop better than others particularly those that are able to:

- Grow and sustain dividends
- Achieve above market earnings growth
- Enjoy a dominant market position
- Have sound financials.

Some standouts which we also highlight in this report include: **Sydney Airport**, **Baby Bunting**, **Beston Global Foods** and **Qantas**.

Our core strategy continues to err on the side of caution, and we recommend investors:

- Hold more cash than they have in the past
- Balance portfolios across assets that offer above average earnings and income growth
- Exercise patience but not complacency

Important disclosures regarding companies that are the subject of this report and an explanation of recommendations can be found at the end of this document. Morgans Financial Limited ABN 49 010 669 726 AFSL 235410 A Participant of ASX Group A Professional Partner of the Financial Planning Association of Australia Level 29 123 Eagle Street Brisbane QLD 4000 Australia Phone 1800 777 946

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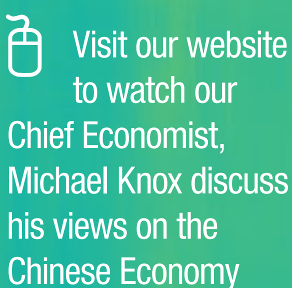
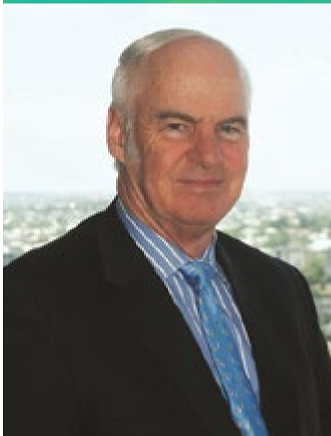




A fresh take on the Chinese economy

We believe the Chinese economy is widely misunderstood. This is especially true of the GDP numbers, with commentators' common objection being how the authorities can come out with its GDP numbers faster than the US or other northern hemisphere countries and still be accurate.

The answer is that GDP is not a census. GDP is a survey. GDP is not defined by counting everybody in every individual industry and measuring their contribution to output. This is done roughly every five years. When it is done, it is called an industrial or economic census. The last time this was done in China, it showed that the service economy was bigger than previously thought. The size of the Chinese economy was re-estimated upwards as a result. A similar event to this happened in India last year. The Indian economy was also estimated as larger than previously thought.

Some economists who talk about China also have their own private models of what GDP might look like. One published last year suggested that growth was lower than the GDP estimate. My examinations of these types of models reveal that most of the measures were based on the industrial economy that include such measures as electricity consumption and bulk freight which is closely tied to heavy industry.

The problem with these types of models is that they don't take account of the continuous and high degree of structural change that is part of the Chinese economy. In particular, such measures generally don't include measures of activity in the rapidly expanding services sector. This change in structure towards services is increasingly evident from the published Chinese GDP numbers.

The Chinese National Bureau of Statistics reported in Q4 the economy grew by 6.8%. The value added by primary industry (or agriculture) was 6,086 billion RMB with the sector growing by 3.9%. The value added for secondary industry (or manufacturing) was 27,427 billion RMB with the sector growing by 6.0%. They further report the value added for tertiary industry (Services) was 34,156 billion RMB, growing by a strong 8.3%.

The implications for the Australian market are significant as the shifting composition of growth suggests that the China investment thesis has changed.

So what we learn from this is that the services sector is rapidly outperforming the manufacturing sector. This means that the Chinese government is successfully moving its domestic activity away from manufacturing towards services.

The first thing that is remarkable about these numbers is that they show that manufacturing is declining as a percentage of Chinese GDP. I have been looking at the Chinese economy for long enough that I have a mental picture of manufacturing as around 60% of GDP. Now, manufacturing has fallen to around 40% of Chinese GDP. Though this figure is comparatively higher than Germany and other service-led economies.

Still, what we see here is structural change in action. The faster growth rate of the services sector is making it a larger and larger part of the Chinese economy. Models based on industrial production are no longer sufficient for reflecting the composition of growth.

Conclusion

The Chinese economy is undergoing structural change. The Chinese government has already been successful in moving China away from being a mostly manufacturing economy towards being a mostly services economy.

Too many economists who look at the Chinese economy place too much emphasis on industrial activity. As time goes by, these economists using these measures will be confined to a world in which they continually underestimate the growth of the Chinese economy.

The implications for the Australian market are significant as the shifting composition of growth suggests that the China investment thesis has changed. The well-trodden path through resources for exposure to ever increasing Chinese fixed asset investment has moved to firms that are leveraged to the rapid rise in middle-class consumer demand for goods and services. Sectors with direct exposure include: food, beverage and agriculture which we explore in more detail in this month's edition of investment watch.

The changing composition in Chinese economic output

Sector	Output in RMB (billions)	Output % of total
Primary (Agriculture)	6,086	9.0%
Secondary (Manufacturing)	27,427	40.5%
Tertiary (Services)	34,156	50.5%
TOTALS:	67,669	100.0%
	$US10.3 trillion	

Source: China National Bureau of Statistics

February reporting season – Beware the unforgiving market

The August 2015 reporting season saw some worrying trends emerge:

- Fewer companies had the confidence to issue 2016 earnings guidance
- Outlook statements were more cautious than usual
- Stocks punished for missing expectations far outnumbered those rewarded for beating them.

Ansell, **Cochlear**, **Seek**, **Downer** and **Computershare** were notable large caps hit. We think this difficult backdrop remains in place as we head into the crucial February reporting period.

Markets are distracted

Broader macro-economic uncertainties including the risks to US and emerging market growth are likely to continue to dominate near term market behaviour in our view. Until the current correction, price growth had far outpaced earnings growth for many of the best performing corporates in 2015 and the painful start to 2016 is a brutal reminder of how swiftly equity risk can be re-priced. Even if stocks meet or exceed February result expectations, we think their performance may be capped while these risks prevail, as occurred in August 2015.

Expectations are modest

Consensus estimates of corporate earnings for industrials stocks were actually modestly upgraded (by 1-5%) over the months since companies last reported in August. We think that market expectations are currently modest, which makes them easier to meet. Conversely those stocks that miss expectations often attract harsh selling. Again, this is what occurred in August 2015.

Earnings and dividends dispersion is higher than normal

The variance in analyst estimates of both earnings and dividends are currently higher than we've seen in the last few reporting periods reflecting less company guidance and higher uncertainty in the operating environment. In a market where reliable dividends have previously commanded a premium, we are particularly averse to those stocks whose dividends may be at risk. Vulnerable sectors include Resources, Energy, Staples and surprisingly Healthcare.

Beware the currency cloud and emerging markets

We think that market expectations may actually be too high for some stocks exposed to multiple jurisdictions (currencies) where earnings are notoriously complex to forecast. **Ansell** and **CSL** suffered for their high expectations last August due to complex currency translation issues. We also flag growing risks to those stocks exposed to the deteriorating outlook for emerging markets including **REA Group**, **QBE**, **Ansell**, **Nufarm**, **Amcor**, **Brambles** and potentially **ANZ**. Note also that we have now removed Amcor from our High Conviction list.

Follow the positive tailwinds

While we are cautious overall, there are several themes we're watching for strong momentum which we think can attract market support. Lower oil prices and ongoing cost deflation will continue to support the transport sector with **Qantas** our standout pick for both its result and possible capital management. This in addition to the falling AUD is also supporting strong demand for domestic tourism with inbound tourism from Asia currently booming. This augurs well for stocks like **Mantra**, **Ardent Leisure** and **Sydney Airport**. Lower fuel prices and a strong Christmas sales period should also support strong results from the retailers however we're very selective given the broader prevailing risks. Our key retail picks for strong results are **Adairs**, **Baby Bunting** and **RCG Corp**. Finally the outdoor media sector surprised many last August and we expect another solid set of results from **APN Outdoor** and **Ooh Media**.

Now is a prudent time to clean up the portfolio

With regard to February results season, we think that more value will be added to client portfolios by selling those stocks most vulnerable to possible disappointment than by trying to pick the winners which we think may struggle to be properly rewarded in this market. Well held names that we see little reason to hold in this market include **Woolworths**, **Brambles**, **Coca-Cola Amatil**, **ASX**, **Monadelphous** and **Duet**.

Resources – Watching and waiting

Our over-arching approach to Resources investing at the sector level remains unchanged. Resources equities move in line with commodities prices. We need to have confidence in upside potential for commodities to become more positive on the sector. Forecasting commodities prices with accuracy is notoriously difficult. Our approach focusses on watching for those market signals we think need to occur to build our confidence in the upside scenario for commodity prices. These include:

- **The topping out of US dollar strength:** Expectations that the US Fed will delay the next rate increase to 2H2016 and a stabilisation in Chinese growth indicators will likely put a ceiling on the USD.
- **An abatement in volatility:** Commodity and mining equity market reactions to small changes in fundamentals remain amplified, elevating market uncertainty.
- **A relief rally in oil:** Mounting evidence that US oil production has peaked and is now declining (US Energy Information Administration) is starting to provide some support that could place a stronger floor under oil prices.

The current commodities downturn has been frustratingly slow for investors, influenced by several less obvious and less rational drivers. Nevertheless, commodity market signals, both good and bad, are now accelerating as the re-balancing phase of the down-cycle gains momentum.

A further supply-side wash-out is a potentially painful but necessary step on the path toward the next up-cycle. The steady accumulation of key signals will help to skew our sector confidence to the upside. It's important to note that while Resources are out of fashion right now, equity markets can quickly and efficiently move ahead of emerging trends. It's quite likely that equity markets will re-rate Resources ahead of a slower moving recovery in fundamentals. Under this scenario companies that have the balance sheet and assets to withstand a prolonged period of depressed commodity prices will stand to benefit when we eventually see a reversal. **BHP Billiton**, **Oil Search** and **Rio Tinto** remain our preferred exposures.

For more information visit our website to view our latest Rocks & Stocks report published 9 December 2015.

Banks – NAB/Clydesdale demerger explained

NAB is pursuing a demerger of 75% of Clydesdale (CYBG) to NAB shareholders and a divestment of the remaining 25% by IPO to institutional investors. Shareholder voting closed January 25 with the stock primarily listed on the LSE, with CDIs on the ASX. We like the strategic rationale of divesting CYBG for NAB, allowing it to re-focus on its core Australian business and think the scheme is likely to be successfully implemented by February 8.

The CYBG investment thesis centres on backing a new, experienced management team to improve a previously poor performing business. The investment highlights are:

- CYBG is an established 175 year franchise;
- Its loan book has been reshaped prioritising safer mortgages, and asset quality has been significantly improved;
- Significant efficiency upside appears to exist with CYBG's cost-to-income ratio currently at 75% (Australian peers 40-45%);
- CYBG has seen strong recent mortgage growth momentum of 10% CAGR between 2012 and 2015;
- CYBG has a strong balance sheet (~13.2% CET1 ratio) and significant provisioning for conduct litigation claims (£1.75bn); and
- CYBG could become a takeover target.

The proposed price range of the IPO is 0.56x – 0.76x FY15 NTA, which implies a share price of £1.75 - £2.35 (A$3.67 – A$4.85). Australian holders need only make a Security Election if they want to receive UK listed CYBG shares which we think is unsuitable for most retail investors. We advocate that holders of 2,000 NAB shares or less participate in the small holdings Sale Facility given their limited holding size.

While we believe NAB management have done a good job in resolving lingering issues for the bank, we believe upside is more difficult from here. A further re-rating, in our view, now lies in NAB's ability to restore growth in its Australian business banking franchise and we were concerned by the 19bps decline in business lending margins in 2H15.

Our key picks in the bank sector remain **ANZ** and **Westpac**. While we acknowledge earnings pressures for ANZ from its institutional business and its exposure to Asia, the stock is now too cheap to ignore in our view, trading below historic averages on every key valuation metric. We also see upside for Westpac, with the company having the strongest FY15 result of the major banks and with the best cost-out opportunity in the sector going forward in our view.

NAB/ Clydesdale de-merger – Key dates	
25/01/2016	Shareholder voting closes
27/01/2016	Scheme and general meetings
3/02/2016	Security Election and Sale Facility Participation closes
5/02/2016	Scheme record date
8/02/2016	Implementation date

Source: NAB

Healthcare – Government reviewing health spend

The Mid-Year Economic and Fiscal Outlook (MYEFO) released in December saw the government put the health sector squarely in the cross hairs, proposing to remove more than A$1.8bn in sector funding to address the growing budget shortfall. The government has targeted more than A$650m in funding to be taken from Pathology and Diagnostic Imaging over the next 4 years.

As a result the pathology and imaging operators of Sonic Healthcare, Primary Healthcare and Capitol Health have all seen share price weakness. Also, the two hospital operators of Ramsay Healthcare and Healthscope are not immune to potential changes in funding. Over the next 12 months the review of the medical benefits scheme will be completed and recommendations will subsequently follow. Underlying the review is a general concern that there is wastage in the health system which can be stripped out and the 'fee for service' philosophy over time replaced by outcomes or evidence based medicine, which the US is adopting.

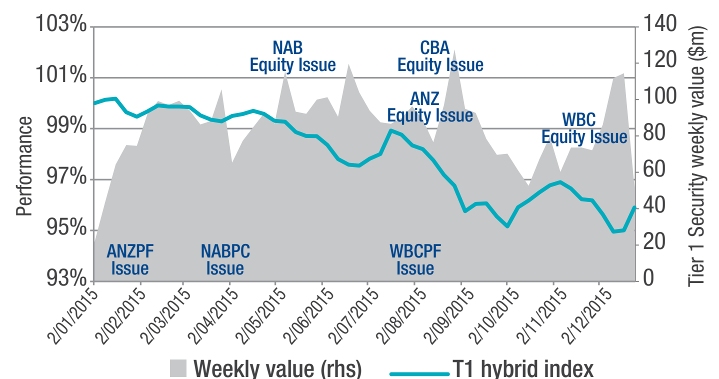
Our view remains that for the short term (six to nine months) the healthcare stocks which are primarily domestically focused will remain volatile pending more detail from the government review.

Longer term, we prefer to stick with the hospital operators **Ramsay** and **Healthscope** as our preferred portfolio stocks.

Fixed Interest Corner

Security prices on average declined across the board last year with the All Securities index falling 3.4%. 2015 issuance was down on 2014 when we saw $7.4b raised by companies, with the majority raised in the form of Tier 1 capital. 2015 was another year where financials dominated primary security issuance and of the $5.6b raised during the year, $4.7b was in the form of Tier 1 securities. The big difference between 2014 and 2015 was the $17.3b of equity raised by the big four banks to bolster capital ratios. Interestingly the substantial amount of equity raised resulted in downward pressure on hybrid securities as investors sold down positions to take up discounted equity raisings. These security price declines have come at a time when hybrid security positions have improved on the back of increased equity buffers. We continue to recommend investors stick to shorter-dated major bank issued securities as yields remain very attractive. Our key picks are **ANZPA**, **CBAPC**, **NABPA** and **WBCPC**.

2015 Tier-1 hybrid performance



Source: IRESS, Morgans

Agriculture and Food – Brand Australia

We believe that the Australian AgriFood sector is well placed in 2016. Asia's appetite for high quality, clean, green, safe Australian food product remains stronger than ever. They are also willing to pay a premium price for 'brand Australia'. This reporting season, we are expecting strong results from:

- **Bellamy's and the The A2 Milk Company** which are benefiting from the infant formula boom
- **Capilano Honey** – is benefiting from rising volumes, increased market share, strong sales across the high margin Manuka honey and its other health and wellness products, and a contribution from recent acquisitions
- **Freedom Foods** – is benefiting from strong industry trends across the dairy, health, allergen-free food and beverage industries; exciting new product launches; expansion in new channels (food service and industrial); offshore sales ramping up; recent capital investment (increased capacity and efficiencies); and new acquisitions
- **Vitaco Holdings** – has seen buoyant trading conditions across the vitamin and dietary supplements, sports nutrition and health food sectors
- **Tassal Group** – strong earnings growth will reflect its recent acquisition of De Costi Seafoods which has allowed TGR to diversify into the broader seafood category
- **Ridley Corporation** – is benefiting from rising demand for protein and consequently solid stockfeed sales.

We recently initiated coverage on Wellard which is Australia's largest exporter of cattle. Wellard's earnings have strong leverage to rising demand for meat, a lower AUD and oil price. Wellard has a clear growth strategy which should underpin solid earnings growth over the next few years. It is also a beneficiary of recent Free Trade Agreements (FTA) and China ratifying the Australia Health Protocol, which means Australia is the first country to be able to export feeder and slaughter cattle to China (we see this as a tremendous opportunity).

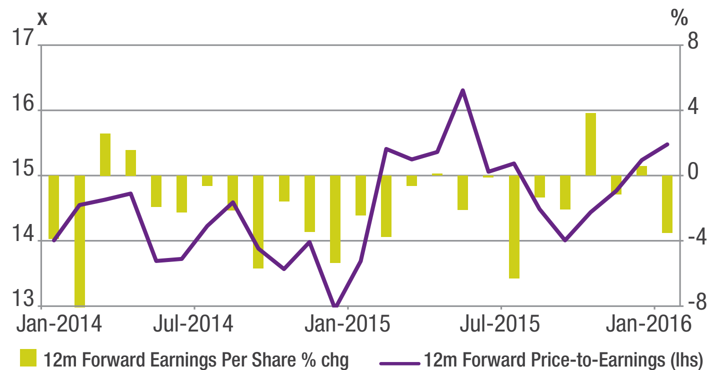
Following recent share price weakness, global Ag chemicals company, Nufarm, is also presenting much better value at these levels. Elders should also have another strong year with cattle prices expected to remain elevated and there will be further gains from management's turnaround program.

Our key picks in the sector are **Beston Global Foods Company**, **Vitaco**, **Bellamy's** and **Wellard**.

Visit our website to view our initiation report on **Wellard** published 21 January 2016.

Retail – It was a good Christmas, but 2016 looks tougher for the sector

ASX retail index – earnings changes and valuation



Source: Factset, Morgans

All our industry channel checks suggest most retailers enjoyed a buoyant Christmas trading period. In particular, we expect the electronics, housewares and outdoor/sports categories to have traded especially well. We therefore expect a strong 2016 first half reporting season for most in the industry.

However, during this time, equity markets have been under pressure and there is plenty of doom and gloom across all areas of global press. Consumer confidence remains fragile and a recent pull-back reflects recent declines in global markets.

Looking forward, we are more cautious on the consumer discretionary sector than we have been in years. 2015 produced some exceptional returns from various retail stocks such as, Domino's Pizza, RCG Corporation, Super Retail Group, Premier Investments and The Reject Shop. However, with valuations looking stretched across the sector and consumers remaining cautious, we struggle to see a situation where multiples expand materially in the year ahead. Therefore, upside to current earnings forecasts is essential when picking stocks in the sector. We also continue to favour stocks with a strong competitive advantage, multiple earnings growth drivers and with catalysts present.

Our key picks in the consumer discretionary space include: **Baby Bunting**, **RCG Corporation** and **Super Retail Group**.

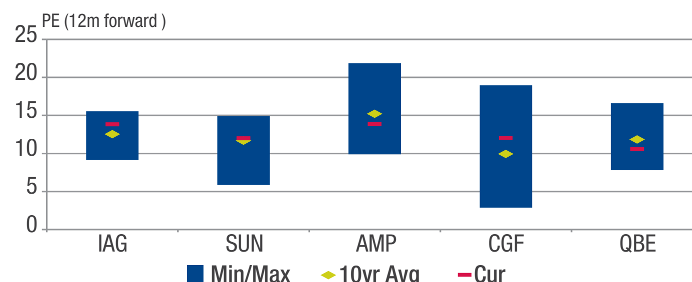
Insurance and diversified financials – As good as it gets?

Following several years of significant price increases, the top-line environment for IAG and Suncorp now appears significantly challenged. Recent results showed minimal organic top-line growth with competition in the Australian insurance market intensifying. We think both insurers need to prove up their growth strategies from here to justify further re-ratings, namely IAG's Asian expansion and Suncorp's organic growth story in banking and life insurance. We think earnings risks remain to the downside for the domestic general insurers, given the favourable weather conditions and increasing competition. However, we believe both companies could do FY16 special dividends.

Following Suncorp's December claims update, we now see it as trading at fair value on ~12.5x FY16F PE. While IAG has indicated it has not experienced the working claims pressures seen by Suncorp, it does trade at a ~2 PE point premium to its key peer (~14x FY16F PE). This multiple is arguably still on peak cycle underlying margins, with fewer options available to further buffer margins post the Wesfarmers acquisition, CGU cost out, and Berkshire quota share arrangement. While we estimate IAG could pay a FY16 special dividend of 13cps, we think Suncorp could pay a 24cps FY16 special.

We maintain a positive view on QBE and Challenger. Despite a difficult global insurance environment, QBE remains cheap, in our view, trading on ~10.2x FY16F PE with upside potential from continued efforts to turn around its US business. For Challenger, while the stock has re-rated, it still trades on a sub-market multiple despite delivering high single-digit EPS growth for the foreseeable future, on our estimates. We also like AMP at current prices, with the stock trading on just ~13.5x FY16F underlying PE. We see upside potential for a further recovery in AMP's Life business and from an equity market improvement over time. Our sector order preference is **AMP**, **Challenger** and **QBE**.

Insurance and diversified financials valuations relative to history



Source: Factset, Morgans

Visit our website for our recent **Insurance and Diversified Financials** sector update published 18 January 2016.

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-february-2016**

Top 100

This month's changes

This month, attention turns from global factors to the domestic reporting season. Investors have had a lot to consider and heightened trading volume demonstrates a high degree of portfolio adjustments has taken place prior to the first opportunity to understand how macro events have affected earnings. Commentary from management will be a critical factor to frame the outlook for 2016.

This month we have removed Amcor (AMC), Ramsay Healthcare (RHC) and Resmed (RMD) from our ASX100 list.

ANZ Banking Group ANZ

Price	$23.87	PE (x)	9.6
Price Target	$34.21	Yield	7.8%
Upside	43.3%	Gross Yield	11.1%

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

Key reasons to buy

- Valuation remains compelling and remains cheapest bank on most metrics.
- We think the CEO's razor focus on improving ROE across the business is the right strategy we also think rationalising the Asian business will help focus the approach to the region.
- Domestic high yield equities including the major banks should remain well supported with further interest rate cuts looking likely in Australia.

Qantas QAN

Price	$3.88	PE (x)	6.6
Price Target	$4.60	Yield	7.9%*
Upside	18.6%	Gross Yield	7.9%*

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.

Sydney Airport SYD

Price	$6.58	PE (x)	nm
Price Target	$6.73	Yield	4.5%
Upside	2.2%	Gross Yield	4.5%

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 29 January 2016.

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-february-2016**

Ex 100

This month's changes

This month we removed AP Eagers (APE) from our high conviction list.

360 Capital Industrial Fund TIX			
Price	$2.42	PE (x)	15.5
Price Target	$2.73	Yield	8.8%
Upside	12.9%	Gross Yield	8.8%

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.

Corporate Travel Management CTD			
Price	$12.08	PE (x)	30.0
Price Target	$14.50	Yield	1.8%
Upside	20.0%	Gross Yield	2.5%

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	$4.27	PE (x)	28.1
Price Target	$4.97	Yield	2.5%
Upside	16.4%	Gross Yield	3.5%

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.

Vitaco VIT			
Price	$2.52	PE (x)	26.5
Price Target	$3.25	Yield	2.1%
Upside	29.0%	Gross Yield	3.0%

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 29 January 2016.

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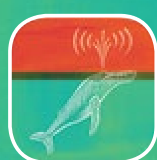

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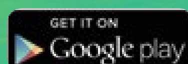

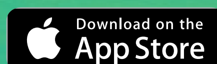

Get ready …

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

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