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Your Money Weekly

Forecast 2019
Fed watch critical as 2019 marks the year the debt piper comes calling

Introduction
Rewind to 14 December 2017. Forecast 2018 – "Could it be a Dog of a year for financial markets?"

"Without forecasting closing year index levels, I believe the US and Australian equity markets will close 2018 at a lower level than the exit level of 2017. The magnitude and cause of a market correction is difficult to predict. Investors are currently oblivious to an exogenous factor but there is abundant fertile ground in which one can sprout.

"In 2017 global equities markets, led by the US, enjoyed a Trumping time. In 2018, they may well suffer a Thumping. Risk assets have enjoyed an extremely favourable environment. Excess liquidity, low interest rates and a high level of complacency have driven risk asset values to high, and in many cases, very stretched levels. US markets have been supported by significant growth in passive investments, led by value agnostic exchange-traded funds, and a record level of share buybacks."

This is not a back-slapping exercise, as the call looked foolhardy in late January with US markets surging to new peaks before a mild correction. They recovered and hit record levels again in September. But the landscape changed quite dramatically in October as one after another, the five previous bullet-proof stocks responsible for most of the market hype, the FAANGs (Facebook, Apple, Amazon, Netflix and Google) stumbled. Without exception they fell by over 20% from their highs in a relatively short time, leading market benchmarks sharply lower. Trade tensions added to uncertainty, while the Federal Reserve (the Fed) continued to tighten monetary policy in response to strong economic data, particularly for employment, with unemployment reaching a near-50 year low. A red flag in my opinion.

There were very few forecasting flat or lower markets this time last year. The overwhelming majority were bullish, some looking for a repeat double-digit performance of 2017 to continue unabated in 2018.

Exhibit 1: Snapshot of 2018

Markets	29/12/17	12/12/18	% Change
Dow Jones	24,719.2	24,527.3	-0.8
S&P500	2,673.6	2,651.1	-0.8
Nasdaq	6,903.4	7,098.3	+2.8
DJ Transport	10,612.3	9,833.8	-7.3
FTSE100	7,687.8	6,880.2	-10.5
DAX	12,917.6	10,929.4	-15.4
Tokyo	22,764.9	21,602.7	-5.1
Hong Kong	29,919.1	26,166.7	-12.7
Shanghai	3,307.2	2,602.1	-21.3
S&P/ASX200	6,065.1	5,653.5	-6.8
S&P/ASX 200 Acc	60,425.7	58,650.4	-2.9
Commodities			
Oil – WTI	US$60.10/barrel	US$51.18/barrel	-14.8
Brent	US$66.52/barrel	US$60.20/barrel	-9.6
Iron Ore 62%	US$72.42/tonne	US$65.97/tonne	-8.9
Gold	US$1,305.10/oz	US$1,250.30/oz	-4.2
Copper	US$3.30/lb	US$2.76/lb	-16.4
Bond Yields			
U.S. – 2 year	1.88%	2.77%	+89bpts
10 year	2.41%	2.91%	+50bpts
30 year	2.74%	3.15%	+41bpts
Australia – 2 year	1.96%	1.94%	-2bpts
10 year	2.63%	2.44%	-19bpts
Currencies			
A$/US$	0.7751	0.7210	-7.0
US$/Yen	112.68	113.26	+0.5
£/US$	135.12	125.95	-6.8
€/US$	120.02	113.66	-5.3

Source: Morningstar Note: bpts = basis points

2019: the year cash becomes a real asset class
At some stage financial markets will have to come to grips with the debt the world has amassed in the post-GFC era and how it will repay it as economic growth slows and central banks rein in liquidity. It is likely more focus on this nagging issue will occur in 2019. It is the Chinese Year of the Pig and I suggest the pig-like behaviour of borrowers in the post-GFC era will come under the microscope. The outcome may not be pleasant, especially for those who have been in hog heaven for some time, oblivious the abattoir gates are near.
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Australia's Leading Independent Investment Newsletter Since 1973

Peter Warnes
Head of Equities Research

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Christmas & New Year
www.morningstar.com.au

While *Your Money Weekly* is on a short summer hiatus, Morningstar.com.au will still regularly feature new content, tools, the portfolio manager and screeners, as well as new research during this period. *Your Money Weekly* first issue for 2019 will be published online Friday 11th January.

Our morning and afternoon emails will continue throughout the summer hiatus, excluding public holidays.

We wish you a Merry Christmas and a Prosperous New Year!

Investors please note:
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The actions of the Fed are likely to be of greater importance to financial markets than trade tensions between the US and China. Trade wars will only add to overall debt-related risks. Fiscal policy, driven by the White House rather than Capitol Hill, remains misplaced with Fed chairman Jerome Powell noting on several occasions the US is on an unsustainable fiscal path. With markets currently mesmerised and focused on US/China trade tension, care must be taken not to be ambushed by the Fed. I suggest investors make cash a real asset class in 2019, not just a balancing item. Any exogenous factor is likely to come from debt markets.

Markets try to predict booms and recessions. The precursor to a recession in the US in 2020 will probably be a meaningful market correction sometime in 2019. In 1966, witty Nobel Prize economist Paul Samuelson quipped "the stock market has predicted nine of the last five recessions." That may be the case, but the Fed has not predicted one recession. The reason – it is not in the prediction game. Its task is to have monetary policy settings in place to deal with the economic environment and the forces within. So, if a recession is on the radar, then interest rates, which reflect monetary policy had better be at a level where meaningful reductions can be made to assist in offsetting or softening the impact of the contraction in activity on unemployment and price stability. The current below-neutral setting does not provide an adequate buffer.

The recent dovish musings of Powell temporarily calmed nervous equity markets. Monetary policy settings are data dependent. They are reactive, not predictive. A further hike on 19 December is probable, taking the federal funds rate from 2.25% to 2.5% and the dot-plot has two hikes in 2019 pushing the rate to 3.0%. This is a 33% increase from the current rate. Highly leveraged corporate America will feel the increasing pain. If the Fed leaves rates unchanged, due to subdued incoming data, somewhat in tandem with the already flattening yield curve which signals slowing economic growth, then equity markets need to be prepared for lower earnings growth. Current market valuations do not sufficiently factor in this possibility. Either way equity markets will have to adjust.

The indebted corporate sector will face increasing difficulty in rolling over existing debt and the price will be meaningfully higher than when it was originally set in the post-GFC liquidity and price binge era. It is vulnerable and potentially hostage to a combination of rising rates and slowing economic activity. Debt markets could face hostile conditions and highly leveraged hedge funds could trigger a shock.

In Australia the repercussions from the Hayne royal commission have been felt well before February's final report is written. Credit policies of all banks have been tightened significantly in addition to macroprudential measures taken to cool the housing market. The fallout is a sharp fall in credit growth, mostly affecting economically sensitive housing credit. Housing price weakness is affecting the psychological household wealth effect, with a knock-on effect on consumer spending. Pressure on household consumption is feeding into GDP growth and the intensity is likely to increase. A sharp slowing in GDP growth in the second half of 2019 is a distinct possibility with a quarter of negative growth an outside chance. The Reserve Bank will not lift interest rates and whispers of a possible cut are becoming louder.

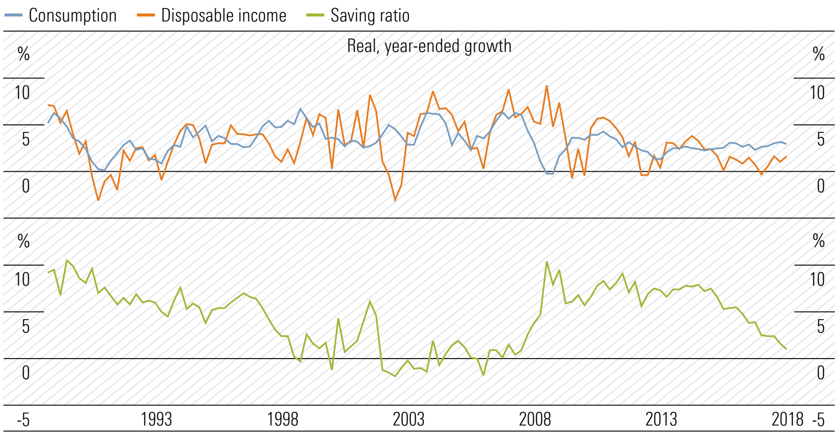
It is increasingly likely global equity markets will encounter strong headwinds and while not trying to predict benchmark levels this time next year, I believe lower, perhaps meaningfully so, is the likely outcome. But this will present opportunity to deploy the cash I recommended we build during 2018. Long-term investors cheer significant market corrections. "Be greedy when others are fearful" - Warren Buffett. Be patient as I don't expect a V-reversal. Look for absolute value, the biggest discounts to long-term fair value, but as always maintain prudent weightings within the portfolio.

Australia – Housing and household consumption the key

Australia's 27-year unbroken record of GDP growth is unlikely to be disturbed in 2019. But a quarter of negative growth is possible should housing prices move sharply lower from current levels. A royal commission-driven credit crunch and an accelerating negative wealth effect would result in a meaningful change in consumer behaviour.

Household consumption, the major contributor to GDP at 55%-60%, dwarfs other contributors individually and collectively. Over the past three years, consumption has been supported by a falling savings ratio which is now at a 10-year low. (Exhibit 2) A reversal would not be positive. It would coincide with a downturn in consumer confidence associated with the decline in housing prices and dent household consumption as more disposable income is saved and consumption reduced.

Exhibit 2: Household income and consumption*



Source: ABS, RBA

*Household sector includes unincorporated enterprises; disposable income is after tax and interest payments; income level smoothed with a two-quarter moving average between March quarter 2000 and March quarter 2002; saving ratio is net of depreciation.

Public demand will continue to be a positive contributor to GDP growth. The federal and state infrastructure pipeline is robust, with at least another three years of high activity. But the contribution is unlikely to grow as capacity constraints are already being tested. Dwelling investment is likely to wane with strong additions and alterations activity offset by falling completions as the new dwelling pipeline empties. Surveys of future capital expenditure plans suggest a recovery in business investment in 2019. But, with a likely change of government in May and the focus on the change in treatment of surplus franking credits, an increasing amount of free cash flow may be directed to distributing franking credits before 1 July 2019, at the expense of growth capex. Business may do both, but gearing ratios would lift at a time when enthusiasm on the outlook for global growth is fading. Non-residential building activity is sluggish and resource investment is in decline as major LNG expansion projects complete.

The contribution from net exports will remain volatile and unreliable. The contribution from LNG exports provided a solid boost in 2018 as volumes increased and Brent prices surged. The reversal in the Brent price has been swift and the October/November weakness will start feeding into lower LNG prices in February/March. In addition, prices of bulks, iron ore and metallurgical coal, are likely to ease through 2019 as China's fixed asset investment growth continues to slow. Thermal coal volumes and prices should be resilient as Asia's energy demand grows. Reduced growth in domestic consumption would be reflected in lower imports, with a positive effect on net exports.

The US/China trade war can affect global supply chains, trade and economic growth. Australian exports are heavily skewed toward China and a sharp slowing in Chinese economic growth and fixed-asset investment will have repercussions for Australian economic growth.

A change in government in May is likely to unsettle. Consumer spending will be subdued prior to and after the outcome. Issues including increased capital gains tax, negative gearing and tampering with surplus franking credits will unnerve investors, particularly superannuants who have experienced unparalleled and persistent meddling in rules and regulations, while trying to follow long-term investment strategies to grow and protect capital and so reduce their dependence on welfare.

United States – Slowing economic growth will expose those swimming naked

- **The Financial Stability Report – A warning**
- **Zombies on the rise**
- **The Federal Reserve will continue to tighten**

The Fed's first published Financial Stability Report reinforces the importance of financial stability as the key element in meeting its dual mandate for monetary policy regarding full employment and price stability. The monitoring framework allows the Fed to distinguish between shocks and vulnerabilities of the financial system. Shocks tend to be sudden and "are typically surprises and are inherently difficult to predict". "Vulnerabilities tend to build up over time and are aspects of the financial system that are most expected to cause widespread problems in times of stress."

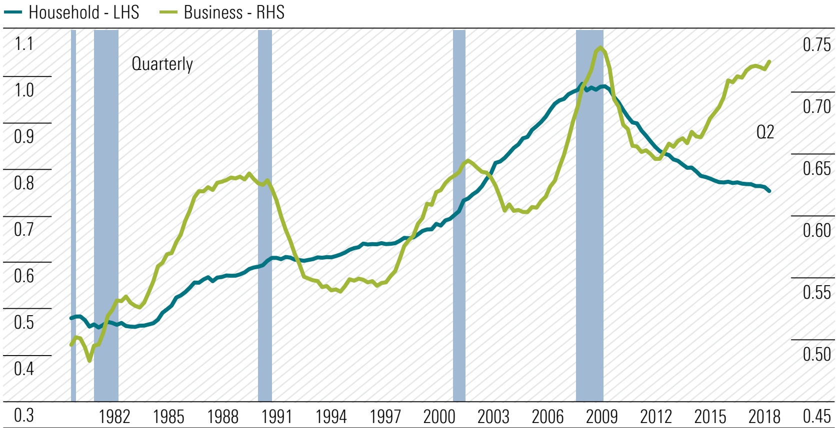
The Fed has narrowed the key categories harbouring potential vulnerabilities down to four.

- Elevated valuation pressures
- Excessive borrowing by businesses and households
- Excessive leverage within the financial sector
- Funding risks

They often interact, and I suggest investors must focus on the implications of the current interaction of the first two. In 2018 the combination of record market indices and record debt was surely a red flag. Normally, elevated valuation pressures and excessive borrowing are conjoined, as both borrowers and lenders are willing to accept greater risk and leverage as asset prices rapidly appreciate. Does this sound familiar?

There is no doubt the vulnerability regarding corporate debt has "built up over time" and currently manifests in record levels. The Financial Stability Report points out, "debt owed by businesses relative to GDP is historically high, and there are signs of deteriorating credit standards." (Exhibit 3) In recent months, debt

Exhibit 3: Business- and household-sector credit-to-GDP ratio



Source: Federal Reserve Board staff calculations based on Bureau of Economic Analysis, national income and product accounts, and Federal Reserve Board, Statistical Release Z.1, "Financial Accounts of the United States."
Note: The shaded bars indicate periods of business recession as defined by the National Bureau of Economic Research. GDP is gross domestic product.

has been growing fastest at companies with weaker earnings and higher leverage. Who are the lenders? Financial institutions, but more likely the junk bond market. The Fed estimates "total risky debt now represents over US$2 trillion in debt outstanding."

"A broad indicator of the leverage of businesses, the ratio of debt to assets for all publicly traded nonfinancial firms, including speculative-grade and unrated firms, has been roughly flat since 2016 but remains near its highest level in 20 years. An analysis of detailed balance sheet information of these firms indicates that, over the past year, firms with high leverage, high interest expense ratios, and low earnings and cash holdings have been increasing their debt loads the most."

I believe 2019, the Year of the Pig, will be the year the excessive borrowing of the past becomes an increasing problem for financial markets. The king of debt and Tariff Man may be in for an uncomfortable ride.

The Zombies

The Institute of International Finance reported global debt reached a new high of US$247 trillion in 1Q18, which includes US$63 trillion of government debt. The debt/GDP ratio exceeded 318%, just below its 3Q16 peak. The pace of the increase is of concern as the quality has declined. Non-financial corporate debt has been responsible for most of the increase in the past five years. There was a marginal decline in 2Q18 but the headline number was still US$247 trillion. Not surprisingly the US, the world's largest economy, accounts for 31.8% or almost one third of the mountain, but only accounts for a little over 15% of the world's GDP.

Low interest rates, sponsored by global central banks during the unprecedented liquidity stimulus of post-GFC quantitative easing, fuelled the debt build-up. With US corporate debt at record levels, the chances of default are increasing. At present, a relatively high 14% of S&P 500 companies have an interest cover of less than one. Put another way, earnings before interest and tax does not cover interest expense, these companies are making pre-tax losses. And if there are no tax credits, losses after tax. This is before interest rates move higher and is somewhat alarming. If companies are currently finding it difficult to service debt, what does it say about the prospect of repayment? Credit impairments then become an issue for lenders, whether the banks or bondholders.

The Bank for International Settlements – the central bank for central banks – refers to these companies as "zombies". The International Monetary Fund describes companies with an interest cover of less than two as either "weak" or "vulnerable". These companies tend to have low productivity and stagnant wages.

By the time the Fed moves to a neutral setting in 2019, with a federal funds rate closer to 3%, the percentage of S&P 500 companies with an interest cover below one will undoubtedly increase. This does not augur well as economic activity is expected to slow through 2019 and margins will be under increasing pressure, making debt serviceability increasingly troublesome. Debt/revenue ratios are nearing levels during the GFC. Already deteriorating corporate credit ratings are attracting more attention with those at the lowest level of investment grade – Baa – exceeding bonds rated A or above. Half of the world's investment grade corporate bonds are rated triple B or below. This is a potentially a dangerous situation as global economic growth slows. We trusted the ratings agencies going into the GFC and are trusting them again 10 years later.

Fed watch a priority

Unemployment is the best indicator of capacity utilisation and at a near 50-year low, the US economy is near full employment, which addresses one of the two issues in the Federal Reserve's dual mandate for monetary policy.

Watch the Fed. If it hikes on 19 December and follows up to two to three more times in 2019, then the defaults will rise meaningfully. If it does nothing and bond yields fall, and the yield curve flattens, a recession could be on the way and the markets are overvalued in that scenario. Either way both equity and debt markets are potentially vulnerable. And as the Fed says, "vulnerabilities tend to build up over time". The US equity market has been on a roll since 2009 and corporates have gorged on debt for a similar period, certainly "over time". Equity prices are somewhat high relative to forecast earnings. Business will only lift capex if it believes the cycle will continue to expand, unlikely this late in the cycle.

No mention yet of the US/China trade tensions now near breaking point despite an "amazing and productive meeting with unlimited possibilities" in Buenos Aires. Will the trade war degenerate to one of attrition? Wikipedia defines attrition warfare as a military strategy consisting of belligerent attempts to win a war by wearing down the enemy to the point of collapse through continuous losses in personnel and material. The war will usually be won by the side with greater such resources. Scary stuff and certainly unsettling for global financial markets.

Eurozone – Slowing growth as the ECB withdraws stimulus

The eurozone's economic growth is slowing and is now below long-term trend. 3Q18 GDP growth slowed to 1.6%. The German 30-year bund yield has fallen 25 points from 1.08% to 0.83% in the last month, the 10s down 22 points from 0.45% to 0.23%. German and French economic growth has slowed. Italy is a mess. These are the three largest economies of the eurozone. Brexit adds uncertainty to both the economies of the U.K. and the eurozone.

Meanwhile, the European Central Bank still intends to cease asset purchases in December despite unconvincing economic data and the potential for the Italian deficit to destabilise the eurozone financial system. Liquidity will be withdrawn from the market, albeit well behind the Fed. The export-sensitive zone is an important cog in the global supply chain and world trade and US protectionism is affecting economic activity.

Commodities Outlook

Several commodities still trade well above their respective marginal cost of production, particularly iron ore, metallurgical and thermal coal. Slowing debt and investment growth in China is likely to weigh on demand for commodities. Some mining companies are also becoming more confident around future volume growth. With industry balance sheets very strong, mining companies have the flexibility to invest to grow supply or make acquisitions. Retaining investment discipline will be a challenge longer-term.

Uranium is still an exception and much of the cost curve remains underwater. That situation is not sustainable, particularly as significant mine supply has been withdrawn from the market. But utilities continue to work through fuel inventories and these need to normalise before prices can recover. Gold is tied to consumption growth in China and India and should fare better than the investment-driven (iron ore, metallurgical coal, copper, alumina) commodities. It's close to where we expect long-term prices to settle. Mineral sands prices have dramatically improved through 2018, and with supply still challenged, we expect these higher prices to persist at least in the medium term. (Mathew Hodge)

Energy

A near three-year 150% rally in the Brent crude price to a US$86 per barrel peak, from sub US$35 lows, was rudely ended in early October. Brent has subsequently fallen around 30% and currently hovers near our mid-cycle US$60 per barrel forecast, the level we still believe is required to incentivise new capital expenditure sufficient to satisfy global demand, while not over-stimulating US shale production, the world's marginal source of supply. That's not to say Brent prices won't over-shoot to the downside, as has happened in the past, or equally might rally again on a new supply disruption due to geopolitical issues.

Oil supply, led by the US, has predictably risen sharply on healthier prices. The International Energy Agency expects non-OPEC output to rise by 2.3 million barrels per day (mmbpd) this year. The world produced 92.6mmbopd in 2017, with the US for the first time becoming the largest producer at 13mmbopd. Saudi Arabian-led OPEC, and non-OPEC member Russia, have agreed to do most of the heavy lifting in an agreed 1.2 mmbpd production cut. This has been a key factor in halting further sharp price decline, for now. But OPEC is famously dis-united, Iran has not promised any cuts, and the announcement by Qatar that it will leave OPEC to concentrate on LNG exports, only muddies the waters.

We view the uncertainty as all part of the usual noise, preferring to concentrate on genuine longer-term underlying fundamentals of supply and demand. This is particularly so for our ASX-listed energy companies for whom the Asia LNG price is the more important earnings determinant in any case, notwithstanding the ongoing LNG contract reference to oil price. As discussed later in our Energy sector write-up, we forecast surging Chinese LNG demand to drive an increased global 2025 supply gap of 160 billion cubic metres, in turn supporting a healthy unchanged US$8.50/mmBtu LNG price. The Brent price pull-back has afforded value once again in key energy names, including Woodside (WPL) the cheapest with a price/fair value of 0.67, followed by Santos (STO) with a price/fair value of 0.73. (Mark Taylor)

Economics

Dark clouds descending on the domestic front as global uncertainty rises

John Likos, CFA
Director of Equity Research, Hybrids and Financials

Shaun Ler
Associate Equity Analyst

Key Themes for 2019
If we thought 2018 was going to be a tough year for investors, then buckle up, as our 2019 economic outlook is even more cautious. We expect unemployment to reverse and start moving back up, inflation to remain weak, consumer spending to remain constrained and GDP growth struggle around 2.8%. A lower A$ could absorb some of the pain, however, this will likely be a minor offset to the headwinds. Against this backdrop, we expect cash rate expectations to temper further, with increased chatter surrounding potential rate cuts. Subsequently, we see lower government bond yields as investors look to safe-haven investments.

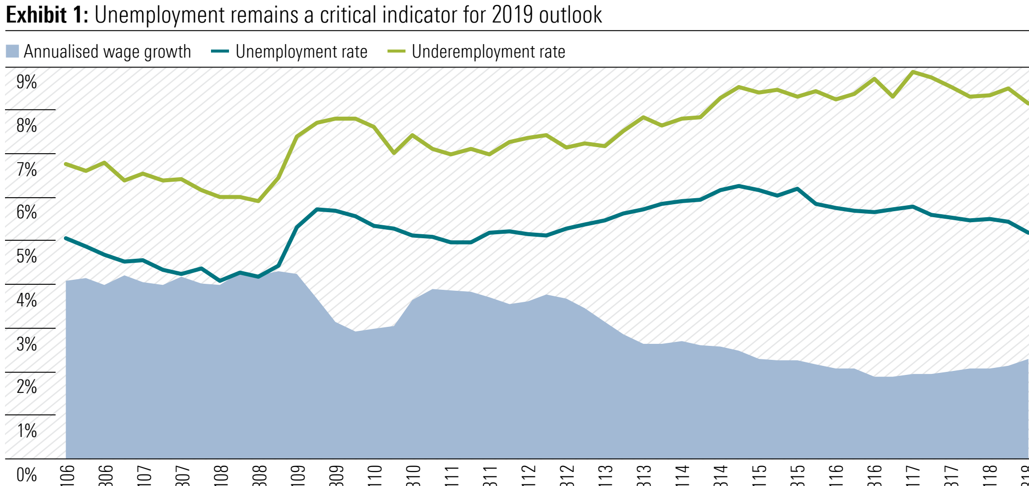
A turn in unemployment trends likely to signal greater problems ahead: While Australia has benefited from a downward trending unemployment rate over many years to today's reported number of 5.0%, we believe this is likely to start trending the opposite direction. We don't know the precise number, but we see it moving towards 5.5%. We don't necessarily share the Reserve Bank of Australia's (RBA) confidence in further reductions in unemployment, due to what we see as material underemployment in the economy as well as softness emerging in the economy – particularly in high employment areas such as construction.

Inflation to remain weak, as wage growth continues to disappoint: Most recent annual CPI data has Australian inflation tracking at about 1.9%, or 1.75% in underlying terms, a number we don't expect much divergence from in 2019. Again, we don't share the RBA's optimism in expecting CPI to climb to 2.25% in 2019 especially in the event unemployment picks up and further dents an already weak annual wage growth number of about 2.2%. Otherwise, key CPI components are likely to remain under significant price pressure including food, clothing, and housing. We might see some imported inflation if the A$ falls below 70 cents for a prolonged period, as we expect, but this is likely insufficient to drive any meaningful increase in underlying inflation.

Consumer spending to remain lacklustre as money is diverted elsewhere: An uptick in unemployment amidst a backdrop of weak wage growth is likely to keep consumer spending subdued. This scenario is further exacerbated when we factor in the record high levels of household indebtedness creating a need to first channel any disposable cash flows towards debt servicing before anything else – especially discretionary consumption. Retail sales will likely continue to suffer, as household distress increases amid higher borrowing rates.

Domestic GDP to fall below Reserve Bank expectations as domestic rate hikes Off the table: As the main driver of domestic growth, consumption weakness is likely to drive GDP growth below the RBA's 2019 forecast of "about 3.5%". It really is difficult to see this scenario playing out, with our expectation to be closer to 2.8%. While this may remain the envy of many developed nations, it remains insufficient to drive inflation and wage prices out of their long-term slumber. Merely "ticking-along" is not enough for this purpose. As a result of our moderate growth expectations, we do not see the RBA increasing the cash rate in 2019, with rate risk to the downside. M

Exhibit 1: Unemployment remains a critical indicator for 2019 outlook



Source: Thomson Reuters

Banks

Royal Commission overshadows fundamentals, but competitive advantages are intact

David Ellis, CPA
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Banks, Insurance and
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John Likos, CFA
Director of Equity
Research, Hybrids
and Financials

Major Banks Earnings Outlook
Neutral →

Major Banks Valuation Outlook
Positive ↗

Regional Banks Earnings Outlook
Negative ↘

Regional Banks Valuation Outlook
Neutral →

Key Themes for 2019

The operating environment for the major banks is becoming increasingly uncertain. The combined effects of increasing regulatory oversight, potential government change, a weakening housing market, slowing credit growth, slowing Chinese economic growth, rising global interest rates and investment market jitters should keep the major banks under pressure in 2019.

We have a moderately positive economic outlook, and this is important for the major banks, being integral parts of the economy. A severe economic downturn is unlikely despite some domestic and global headwinds, and we remain confident dividends are sustainable due to good capital generation, modest credit growth and strong loan quality.

On the other hand, we expect Regional Banks to have a more challenging year. Relative to the major banks, they continue to display lower levels of capital, less diversity of funding and subsequently greater pressure on profitability and greater concentration in their loan books.

Widespread competitive, funding and regulatory pressures should keep net interest margins (NIMs) under pressure, limiting earnings growth in 2019. Rising loan losses should also detract from profits, though the timing and extent is uncertain.

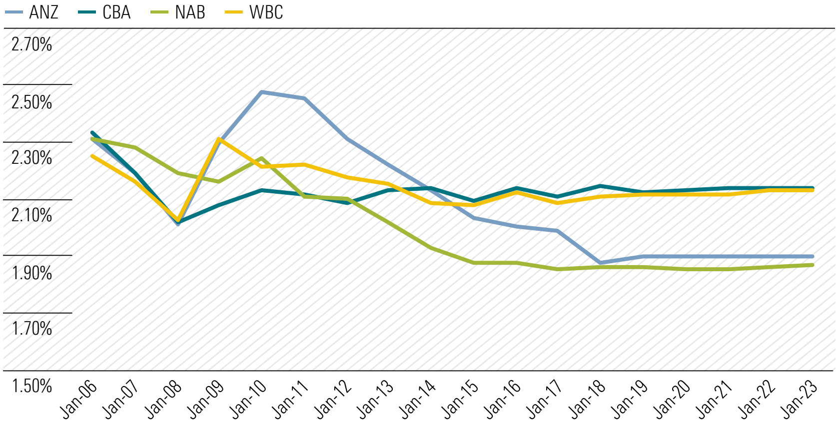
Balance sheets are well-capitalised with key metrics in the top quartile of global peers. The feared major bank capital deficit is quickly turning into a surplus, with capital returns likely to continue in 2019. ANZ will likely boost its on-market buyback in FY19. Commonwealth Bank could announce an on-market buyback or pay a special dividend in late calendar 2019. National Australia Bank and Westpac will maintain sector-high dividend payout ratios.

Despite concerns from increased public and political scrutiny, we are confident the risks to the highly profitable banking oligopoly are well contained. Wide economic moats based on cost advantage and customer switching costs continue to bestow considerable pricing power, protecting profits from the rising funding costs, but not from increasing regulatory and compliance costs.

Most/Least Preferred Stocks

The major banks offer attractive dividend yields relative to alternatives. Fully franked dividend yields are between 6.1% and 8.1%, grossed up to 8.7%-11.6%. All four major banks are trading below our fair value estimates. In order of preference, we like Westpac, Commonwealth Bank, National Australia Bank, and ANZ.

Exhibit 1: Major bank net interest margins - Outlook stable due to business mix changes and loan repricing



Source: Company accounts, Morningstar forecasts

Featured Recommendations (as at 12 Dec 2018)

	Recommendation	Moat Rating	Uncertainty Rating	Adj. EPS (cps) FY18A	Adj. EPS (cps) FY19F	EPS CAGR (%) 5yr	DPS (cps) FY18A	DPS (cps) FY19F	Franking FY18A (%)	PER (x) FY19F	Div.Yld (%) FY19F	Share Price ($)	Fair Value ($)	Price/Fair Value
ANZ Bank ANZ	★★★★	Wide	Medium	223.4	238.6	3.1%	160.0	161.0	100.0%	10.4	6.5%	25.20	29.00	0.87
Commonwealth Bank CBA	★★★★	Wide	Medium	568.6	561.7	1.5%	431.0	433.0	100.0%	12.2	6.3%	70.08	80.00	0.88
National Australia Bank NAB	★★★★	Wide	Medium	221.2	230.4	3.9%	198.0	198.0	100.0%	10.2	8.4%	23.89	30.00	0.80
Westpac WBC	★★★★	Wide	Medium	236.2	241.0	2.1%	188.0	190.0	100.0%	10.4	7.6%	25.47	33.00	0.77

Insurance

General insurers to benefit from improved conditions in 2019

The private health insurance sector continues to benefit from profitable business models, but political uncertainty, ongoing affordability issues and regulatory capital uncertainty will likely weigh on share prices. Like general insurers, the health insurers continue to improve operational efficiency, supporting modest earnings growth.

David Ellis, CPA
Senior Equity Analyst
Banks, Insurance and Diversified Financials

Earnings Outlook
Positive ↗

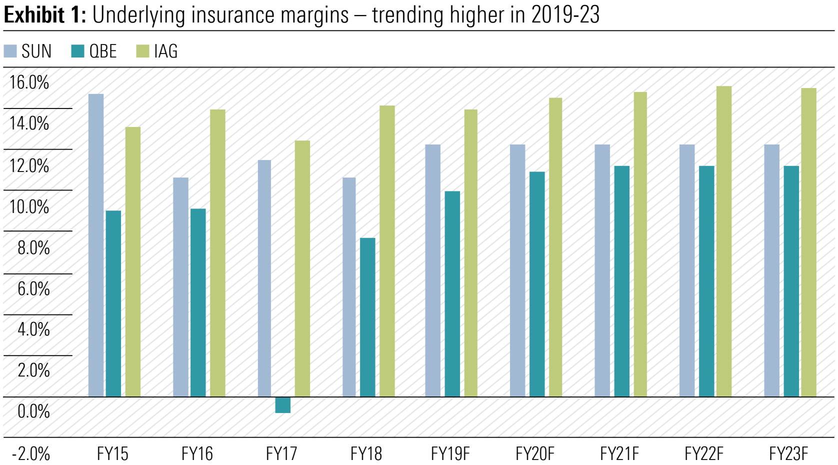
Valuation Outlook
Positive ↗

Key Themes for 2019

The outlook for the general insurers is positive with good underlying revenue and margin momentum expected to continue in 2019. The forecast earnings per share growth is underpinned by improved pricing, digitalisation, divestment of non-core divisions, investment earnings and capital returns. Increased reinsurance cover will limit net claims costs and improve risk dynamics. Offsetting the positives, higher natural peril costs threaten underwriting profits despite increased allowances.

The focus on claims management simplification and productivity improvement will complement modest revenue growth. Modest premium price increases will provide earnings support in 2019 and 2020. QBE Insurance will benefit from a more focused global business model with domestic insurers leveraging improved business activity.

Exhibit 1: Underlying insurance margins – trending higher in 2019-23



Source: Company accounts, Morningstar forecasts
Note: QBE FY18 is forecast; IAG and SUN FY18 are actual

We foresee the general insurers maintaining strong capital positions due to robust profitability and increased reinsurance arrangements. Risks include: stiff competition from traditional and online rivals; weaker investment markets; deterioration in the Australian economy; weak economic conditions in the U.S. and Europe; an increase in the frequency and cost of natural hazards; and future potential softening in commercial insurance pricing.

Most/Least Preferred Stocks

The general insurers are undervalued with QBE Insurance most attractive. QBE continues the simplification and de-risking journey. The global business model continues to shrink with recently announced asset sales adding to the growing list. In addition to de-risking, simplification allows an operational efficiency program, with underlying fundamentals expected to improve during the next three years. We expect further good progress with legacy issues over the next year.

Suncorp and Insurance Australia Group are trading close to fair value. NIB Holdings and Medibank Private are undervalued trading around 20% below our valuations. In most cases, fully franked dividend yields between 3.0% and 5.8% grossing up to 4.3% to 8.1% are attractive.

In order of preference, we like QBE, Insurance Australia Group and Suncorp. Insurance broker Steadfast Group provides attractive earnings growth and is trading modestly below our fair value.

Featured Recommendations (as at 12 Dec 2018)

	Recommendation	Moat Rating	Uncertainty Rating	Adj. EPS (cps) FY18A	FY19F	EPS CAGR (%) 5yr	DPS (cps) FY18A	FY19F	Franking FY18A (%)	PER (x) FY19F	Div.Yld (%) FY19F	Share Price ($)	Fair Value ($)	Price/Fair Value
Insurance Australia Group IAG	★★★	None	High	43.7	47.4	8.9%	34.0	40.5	100.0%	14.5	5.9%	6.98	7.50	0.93
NIB Holdings NIB	★★★★	Narrow	Medium	29.4	30.3	9.0%	20.0	21.0	100.0%	15.4	4.5%	4.71	6.20	0.76
QBE Insurance QBE*	★★★★	None	High	76.6	89.0	13.5%	46.0	54.0	30.0%	11.2	5.4%	10.28	12.50	0.82
Steadfast Group SDF	★★★	None	Medium	12.7	14.3	8.9%	7.5	8.5	100.0%	18.6	3.2%	2.69	3.00	0.90
Suncorp SUN	★★★	None	High	85.2	97.3	9.6%	81.0	78.0	100.0%	13.2	6.1%	13.04	14.50	0.90

*December year end. FY18 is Morningstar forecast.

Wealth Managers

This will be a difficult year for asset managers, but remember the long game

John Likos, CFA
Director of Equity Research, Hybrids and Financials

Chanaka Gunasekera, CFA
Equity Analyst
Diversified Financials

Earnings Outlook
Negative ↘

Valuation Outlook
Neutral →

Key Themes for 2019

While still positive, we are expecting weaker year on year performance for pure play asset managers as uncertainty in global markets rises and brings with it greater volatility--an expectation the market is clearly already pricing in. We expect the trade war between the United States and China to linger, putting greatest pressure on Platinum Asset Management; Brexit to remain messy and potentially expensive for Pendal Group, through their U.K. subsidiary JO Hambro; and U.S. equity valuations to continue to come under pressure amidst increasing concerns of political gridlock and a weakening economy, thereby putting pressure on Magellan Financial Group.

The long-term dynamics of the industry remain favourable. As highlighted in our 2018 outlook, these include favourable demographic trends, an increasing pool of superannuation funds and continued population growth. Furthermore, pure play fund managers such as Magellan, Platinum and Pendal should continue to benefit from their strong brands, track records of top quartile long-term returns and expertise in global equity markets - where Australian investors remain grossly underinvested. Poor short-term performance and industry funds in-housing management of Australian equities may continue to affect Perpetual and we expect it to rely on its other segments of financial advice and corporate trust for growth.

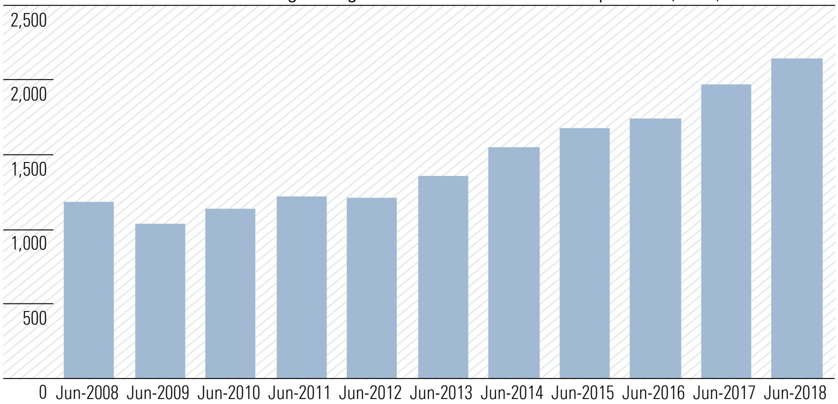
Competition will remain intense and keep fees down, especially for replicable strategies, as cheap passive investments like ETFs continue to take market share. We anticipate further fee pressure over the long term but believe the moat-rated wealth managers are better placed than their no-moat-rated peers to contend with these dynamics. We do not expect to see any material fee changes from our three pure play asset managers in 2019.

The Royal Commission Final Report due in February will make 2019 a critical year for both AMP and IOOF. The Interim Report hinted at structural changes to Australia's financial advice and superannuation landscape which is likely to impact their vertically integrated business models. Both companies have suffered fallout from the royal commission, and their future fortunes will depend heavily on the recommendations in the Final Report. AMP also has a new Chair and CEO, with the new CEO given a mandate to be a change agent. After APRA's unprecedented action against it, IOOF will also have a brand new leadership team, so 2019 is going to be a major transition year for both companies.

Most/Least Preferred Stocks

Our preferred pure play asset manager is Pendal Group. We believe its greater diversification across asset classes, geography and currency provides a stronger platform to navigate through heightened global uncertainty. Furthermore, we like its increasing focus on income generating strategies amidst the backdrop of an ageing global demographic.

Exhibit 1: Total investment manager long-term FUM outlook remains positive (A$m)



Source: Australian Bureau of Statistics

Featured Recommendations (as at 12 Dec 2018)

	Recommendation	Moat Rating	Uncertainty Rating	Adj. EPS (cps) FY18A	Adj. EPS (cps) FY19F	EPS CAGR (%) 5yr	DPS (cps) FY18A	DPS (cps) FY19F	Franking FY18A (%)	PER (x) FY19F	Div.Yld (%) FY19F	Share Price ($)	Fair Value ($)	Price/Fair Value
AMP AMP*	★★★★	Narrow	High	29.0	22.7	-7.3%	18.0	17.0	67.0%	10.0	7.5%	2.33	2.85	0.82
Pendal Group PDL	★★★★	Narrow	Medium	64.4	63.0	3.2%	52.0	52.0	15.0%	12.4	6.7%	8.01	11.00	0.73

*December year end. FY18 is Morningstar forecast.

Property/REITs

Apart from the developers, values remain stretched

Tony Sherlock, CA, CPA
Senior Equity Analyst
Property & REITs

Earnings Outlook

Positive ↗

Valuation Outlook

Neutral →

Key themes for 2019

We forecast nearly all property companies generate earnings growth, underpinned by contractual rental escalations in most leases and sustained high occupancy.

Our wariness of shopping centres REITs persists, as we believe rents are too high against an expectation of slower consumer spending ahead. Pressures on retailer tills continue to mount: surging growth in online retail, slowing wages growth, high household leverage and falling home prices. Landlords are adopting cookie-cutter strategies to reallocate space to beauty services, medical and dining. But there is a limit to how much space can be converted to these new categories, which points to lower long-term rent growth.

Fundamentals for office assets in Sydney and Melbourne remain very strong as vacancy in both markets is near a 10-year low of 4%, leading to strong rent growth for the next 1-2 years before new supply is delivered, a pressure-valve we see triggering a decline in effective rents.

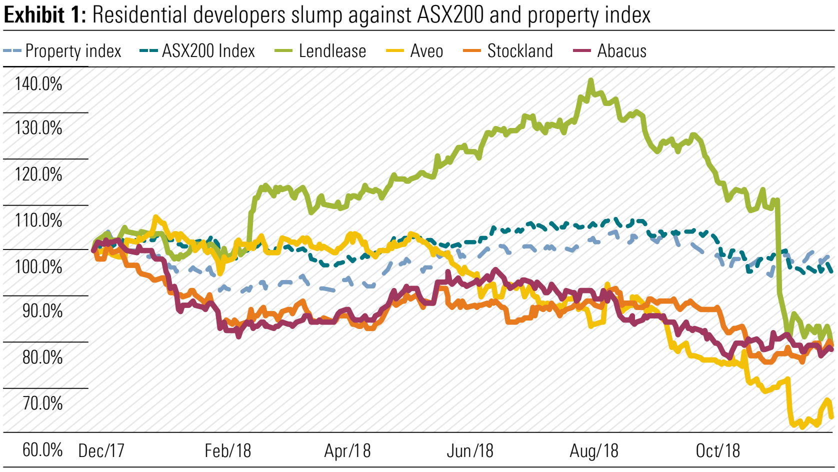
It remains crucial to keep a watching brief on global credit markets as a major negative event remains the most profound risk as it will trigger a repricing of debt and depress property valuations. This is not our central scenario, but one investors should keep in mind given the abnormally low current bond yields and significant rise in global indebtedness over the past decade.

Most preferred stocks

We remain positive on retirement living operators that stand to benefit from favourable demographic trends as the number of elderly persons exploring retirement living options surges over the next five years. The sector has sold off as lower house prices impacts the number of new residents who can afford a retirement unit. Aveo and Ryman Healthcare screen as undervalued.

The fall in Australian house prices, partly due to tightened bank lending standards and regulatory constraints on offshore buyers, has triggered a slide in the share price of companies whose activities include land subdivision and apartment development (Stockland, Mirvac, Lendlease and Abacus), with all but Mirvac screening as undervalued. We forecast a fall in residential development profitability, but not as much as the market, which appears to be baking in not only further material house price declines, but also a prolonged period of weak volumes and margins. We are not so bearish, as most land holdings were procured years ago, well below current pricing. Demand drivers are intact as the Australian population continues to grow solidly and Sydney remains undersupplied, supporting ongoing, but tempered sales volumes.

Exhibit 1: Residential developers slump against ASX200 and property index



Source: Market data, Morningstar analysis

Featured Recommendations (as at 12 Dec 2018)

	Recommendation	Moat Rating	Uncertainty Rating	Adj. EPS (cps) FY18A	Adj. EPS (cps) FY19F	EPS CAGR (%) 5yr	DPS (cps) FY18A	DPS (cps) FY19F	Franking FY18A (%)	PER (x) FY19F	Div.Yld (%) FY19F	Share Price ($)	Fair Value ($)	Price/Fair Value
Abacus ABP	★★★★	None	Medium	22.0	21.0	1.0%	18.0	18.5	0.0%	15.7	5.6%	3.35	3.75	0.89
Aveo Group AOG	★★★★	None	Medium	22.0	15.3	-5.6%	9.0	6.9	0.0%	10.4	4.3%	1.59	2.30	0.69
Lendlease LLC	★★★★★	None	Medium	137.0	80.9	1.6%	69.0	42.0	4.0%	14.1	3.7%	11.59	17.20	0.67
Ryman Healthcare RYM	★★★★	Narrow	Medium	40.7	45.8	11.9%	20.4	22.9	0.0%	24.4	2.1%	11.22	13.00	0.86
Stockland SGP	★★★★	Narrow	Medium	35.5	37.1	0.2%	26.5	27.6	0.0%	10.0	7.5%	3.82	4.15	0.92

Telecommunications

A year of introspection with focus on self-help and 5G-readiness

Brian Han
Senior Equity Analyst
Telecommunications, Media, Leisure

Earnings Outlook
Negative ↘

Valuation Outlook
Negative ↘

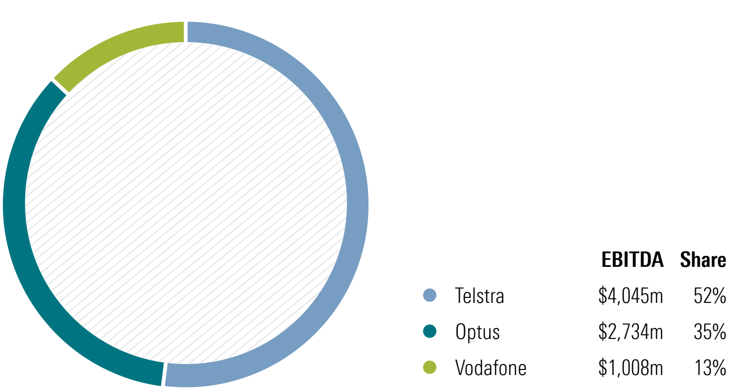
Key Themes for 2019

Competition will remain elevated, as the fight for demanding customers (more data, greater value-add, less cost) continue across all segments. However, the intensity of the competition is likely to be tempered by operators' increasing inward focus, with Telstra busy executing its simplification and the $2.5bn cost-out programs, and TPG Telecom pre-occupied with integrating Vodafone and extracting synergies from the merger (assuming it gains regulatory clearance).

While that may present an opportunity for Optus to be more aggressive in the market, the number-two player will itself be engrossed in planning for 5G mobile deployment—a critical industry upgrade also adding to other operators' exercise in introspection.

The one entity needing some serious introspection is the National Broadband Network (NBN) whose economics remain unsustainable. Maintaining the status quo risks the $51bn project becoming a white elephant, in the face of 5G technology which could bypass the NBN's fixed-line infrastructure over time. A write-down of the project value and a cut in its pricing would be a very positive catalyst for the industry and the consumers, not to mention the NBN itself.

Exhibit 1: A$7.8bn mobile profit pool (fiscal 2018): 3 snouts in the trough is better than 4



Source: Company reports, Morningstar estimates

Most/Least Preferred Stocks

Telstra stands out in an otherwise overvalued sector, with shares trading at a 32% discount to our $4.40 per share fair value estimate. Heightened competitive intensity and NBN's margin-crunching impact are well-known. What is under-appreciated is the upside from the $2.5bn cost-out story and the potential benefits of Telstra's fightback plan for customers. Critically, the pending TPG Telecom-Vodafone merger has positive implications for the industry, ensuring the $7.8bn Australian annual mobile profit pool remains a three-player market, as opposed to sharing it with the aggressive TPG Telecom as a stand-alone new entrant.

Shares in TPG Telecom are trading at a 24% premium to our $6.10 per share fair value estimate as a stand-alone entity. In stark contrast to scepticism regarding Telstra's turnaround plan, the market is not only assuming the proposed merger with Vodafone merger will complete, but is baking in significant synergies., to the tune of $550m. This is not impossible but is easier done on a spreadsheet than in real life, especially as it represents over 20% of Vodafone's current cost base. The potential integration risk will be particularly acute, given the two companies' diametrically-opposite corporate culture, with TPG Telecom a nimble, cost-conscious operator ruled with an iron-fist by its founder and Vodafone Australia an A1 prototype corporate bureaucracy.

Featured Recommendations (as at 12 Dec 2018)

	Recommendation	Moat Rating	Uncertainty Rating	Adj. EPS (cps) FY18A	Adj. EPS (cps) FY19F	EPS CAGR (%) 5yr	DPS (cps) FY18A	DPS (cps) FY19F	Franking FY18A (%)	PER (x) FY19F	Div.Yld (%) FY19F	Share Price ($)	Fair Value ($)	Price/Fair Value
Chorus Limited CNU-NZ*	★★	None	High	16.1	11.1	4.5%	22.0	23.0	100.0%	42.2	4.9%	4.72	4.00	1.18
Telstra Corporation Limited TLS	★★★★★	Narrow	Medium	30.0	21.6	-11.2%	22.0	15.0	100.0%	14.2	4.9%	3.03	4.40	0.69
TPG Telecom Limited TPM	★★	Narrow	High	46.7	37.3	-3.3%	4.0	5.0	100.0%	20.8	0.6%	7.74	6.10	1.27
Vocus Group Limited VOC	★★	Narrow	High	20.4	16.6	6.5%	0.0	0.0	0.0%	20.6	0.0%	3.40	2.90	1.17
Spark New Zealand Limited SPK-NZ*	★★	Narrow	Medium	22.9	22.9	-2.7%	25.0	25.0	75.0%	18.7	5.9%	4.33	3.70	1.17

*Dividends for Spark New Zealand and Chorus are fully imputed for New Zealand residents. Australian investors receive supplementary dividends. Figures in NZD.

Media

Tune in for blurring distinction between Old and New media; Watch out for housing impact

Brian Han
Senior Equity Analyst
Telecommunications, Media, Leisure

Earnings Outlook
Neutral →

Valuation Outlook
Positive ↗

Key Themes for 2019

Acceptance of a permanent change in consumption behavior is likely to force traditional media companies to accelerate investment in new-age, digital media. For instance, the combined Nine-Fairfax will leverage its size and scale to turbo-charge Stan (subscription video on demand) and 59%-owned Domain (digital real estate listing portal). Similarly, News Corporation will boldly evolve pay TV into a hybrid model (high-end set-top-box, on-demand digital streaming), while free-to-air TV operators will fully commit to broadcast video on demand. Southern Cross Media will invest heavily to become the first mover in the premium local-content podcasting space.

These initiatives will incur near-term costs, and partly cannibalise existing revenue streams. However, they are necessary to ensure the long-term future of these traditional media entities, especially at a time when trust in digital media is waning and emerging signs of consumers gravitating back to established media brands for 'true' news and less threat of privacy data abuse.

The wild card risk is cyclical, depending on the length and severity of the current downturn in house prices. While we maintain our low single-digit growth rates across the main traditional advertising platforms, a prolonged weakness in the housing market could sap consumer confidence and impact advertising expenditures—a dangerous backdrop for a largely fixed-cost industry.

Most/Least Preferred Stocks

Shares in Southern Cross Media are our most preferred in the sector, trading at a 24% discount to our $1.40 per share fair value estimate. Relatively resilient radio earnings account for over 70% of group total, while balance sheet strength (net debt/EBITDA of 1.8) ensures dividend sustainability (currently yielding 7.2%, fully franked) and provides capacity to invest in new media.

Nine, News Corporation and oOh!media are all trading at discounts of more than 10% to our fair value estimates. There are cyclical uncertainties in the near-term, but these companies' long-term destinies are largely in their own hands. We expect Nine to successfully extract $62m in synergies from the Fairfax merger (versus guidance of $50m), News Corporation to continue executing on its strategy to diversify away from print media, and oOh!media to leverage the structural tailwinds for the outdoor advertising industry (driven by inventory digitisation, increasing audience) with synergies from the recently-acquired Adshel business ($17m forecast versus management projection of $15m to $18m).

Exhibit 1: Drilling down into potential synergy sources for Nine-Fairfax merger (A$m)

	Nine	Fairfax	Total	% cut/ incremental	Saving/ EBITDA**
Base case:					
Corporate cost	16	24	40	50%	20
Newsroom/gathering	155	100	255	0%	0
Other non-content*	227	196	423	10%	42
Cost synergy sub-total					62
Advertising revenue (ex Domain)	1,152	616	1,768	0%	0
Domain advertising revenue	0	356	356	0%	0
Revenue synergy sub-total					0
Base case total					**62**

Source: Company reports, Morningstar estimates
* For Nine, non-programming. For Fairfax, promotional/advertising, communication, maintenance/IT, professional fees
** Incremental revenue x assumed margin to arrive at extra EBITDA i.e. advertising revenue (ex Domain) at combined average group margin of 17.8%, Domain revenue at Domain's margin of 33.3%.

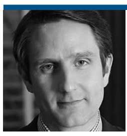
Featured Recommendations (as at 12 Dec 2018)

	Recommendation	Moat Rating	Uncertainty Rating	Adj. EPS (cps) FY18A	Adj. EPS (cps) FY19F	EPS CAGR (%) 5yr	DPS (cps) FY18A	DPS (cps) FY19F	Franking FY18A (%)	PER (x) FY19F	Div.Yld (%) FY19F	Share Price ($)	Fair Value ($)	Price/Fair Value
Nine Entertainment Co. Holdings NEC	★★★★	None	High	17.9	20.6	-0.8%	10.0	12.0	100.0%	7.5	7.8%	1.51	2.00	0.76
News Corporation NWS	★★★	None	High	57.1	51.6	18.8%	25.8	26.8	0.0%	34.1	1.5%	17.54	21.00	0.84
Oohmedia Limited OML*	★★★	None	High	20.7	30.9	10.9%	13.0	17.0	100.0%	13.2	4.2%	4.13	4.95	0.83
Seven West Media Limited SWM	★★★	None	High	9.5	10.5	-1.7%	0.0	0.0	0.0%	5.5	0.0%	0.59	0.70	0.84
Sky Network Television Ltd SKT-NZ**	★★★	None	High	30.6	23.3	-6.5%	15.0	13.0	100.0%	9.2	6.1%	2.06	2.50	0.82

* December year end. FY18 is Morningstar forecast. ** Dividends for Sky Network TV are fully imputed for New Zealand residents. Australian investors receive supplementary dividends. Figures in NZD.

Technology

Mostly overvalued but some opportunities emerging



Gareth James, CFA
Senior Equity Analyst
Technology

Earnings Outlook
Positive ↗

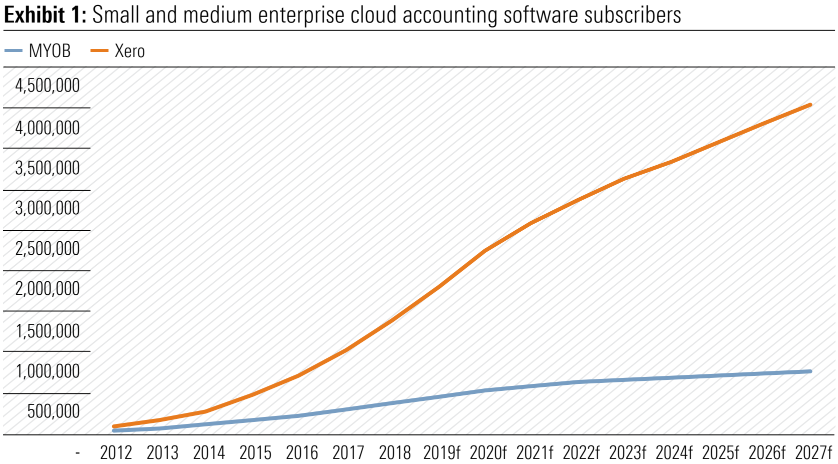
Valuation Outlook
Negative ↘

Key Themes for 2019

The technology sector has been on a rollercoaster ride in 2018 with many stocks still overvalued but value emerging in patches. The earnings outlook remains strong for most companies, but we think investors are overpaying for high revenue growth which often comes with little or no profits, as is the case with Wistech Global and Xero. In both cases, investors are enamored by the prospect of a global platform with network effects, but we think too much growth is being priced in too soon.

Our preference is for more established and profitable businesses, such as the classified advertising platforms, which already have network effects and narrow economic moats. Carsales.com and Seek are undervalued and fairly-valued, respectively. REA Group and Domain are being affected by the real estate market downturn, but we expect both to retain their strong competitive positions and earnings to eventually recover.

Exhibit 1: Small and medium enterprise cloud accounting software subscribers



Source: Company filings, Morningstar estimates

The transition of on-premise software to the cloud and the increasing dominance of mobile devices as the preferred choice of hardware remain key themes which underpin strong revenue growth for software companies like MYOB, Technology One, Xero, and Wisetech Global.

We expect established financial services technology stocks such as ASX, Computershare, and IRESS to deliver mid-single-digit revenue CAGRs over the next decade. All are largely insulated from potential negative consequences from the Financial Services Royal Commission and should continue to grow broadly in-line with the economy. However, we forecast a 5-year EPS CAGR of 11% for Link Administration due to the benefits from integrating the Capita Asset Services acquisition and the increased investment in real estate platform, PEXA, and consider the stock to be undervalued.

Most/Least Preferred Stocks

Our preferred stocks include narrow moat rated Link Administration, Carsales.com, G8 Education and Charter Hall Education Trust. We view Xero, Wistech Global, and Netwealth as the most overvalued stocks in the sector.

Carsales.com's share price has fallen due to concerns about weak automotive sales and the impact of credit tightening on its finance business. However, we consider these issues to be cyclical and expect the business to be insulated to a large degree by its network effect-based economic moat.

We expect both G8 Education and Charter Hall Education Trust to benefit from the boost in childcare demand following the recent introduction of the Child Care Subsidy and associated improvements in childcare center occupancy rates.

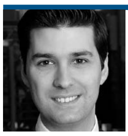
Featured Recommendations (as at 12 Dec 2018)

	Recommendation	Moat Rating	Uncertainty Rating	Adj. EPS (cps) FY18A	Adj. EPS (cps) FY19F	EPS CAGR (%) 5yr	DPS (cps) FY18A	DPS (cps) FY19F	Franking FY18A (%)	PER (x) FY19F	Div.Yld (%) FY19F	Share Price ($)	Fair Value ($)	Price/Fair Value
Carsales.com CAR	★★★★	Narrow	Medium	50.7	57.9	13.1%	44.2	49.0	100.0%	19.0	4.5%	11.29	14.50	0.78
Charter Hall Education Trust	★★★	None	Medium	17.3	17.6	5.1%	15.1	16.0	0.0%	16.6	5.5%	2.91	3.20	0.91
G8 Education Limited GEM*	★★★★	None	High	18.4	20.8	6.8%	14.0	16.0	100.0%	13.6	5.6%	2.83	3.50	0.81
Link Administration LNK	★★★★	Narrow	Medium	38.9	46.4	10.6%	20.5	28.0	100.0%	14.8	4.1%	6.83	8.50	0.80

* December year end. FY18 is Morningstar forecast.

Gaming

Vicious market sell-off creates attractive opportunities across the gaming sector



Daniel Ragonese
Equity Analyst
Gaming, Consumer

Earnings Outlook
Positive ↗

Valuation Outlook
Positive ↗

Key Themes for 2019

VIP gaming will be the main driver of casino revenue growth, as the market continues to recover from the recent tumultuous period, whereas main-floor gaming will be limited to the low single digits. In the near term, Crown Resort's focus will remain on the construction of the $2.2bn Sydney casino, which is on track for completion by FY22 and within budget. Additionally, the balance sheet remains in pristine condition following the recent divestments.

Aristocrat Leisure's high-teen FY19 EPS growth prospects are underpinned by increasing contributions from digital gaming, along with further market share gains in the North American leased slot machines. Margins will soften, although this is not concerning as it reflects additional investment into design and development, digital user acquisition costs, and mix shift towards lower margin digital. Ainsworth Game Technology, on the other hand, is facing substantial near-term earnings pressure, reflecting weaker sales in North America and ongoing competitive pressure in the local market.

Tabcorp will deliver strong earnings growth, although this will be largely due to the first full year contribution from the recently acquired Tatts. The company's primary focus in the near term will be integrating Tatts' operations and unlocking the guided $130m in annual synergies, which we believe is achievable within the next few years. Near-term priorities will be migrating the UBET brand to TAB, improving yield, and cutting costs by consolidating overheads.

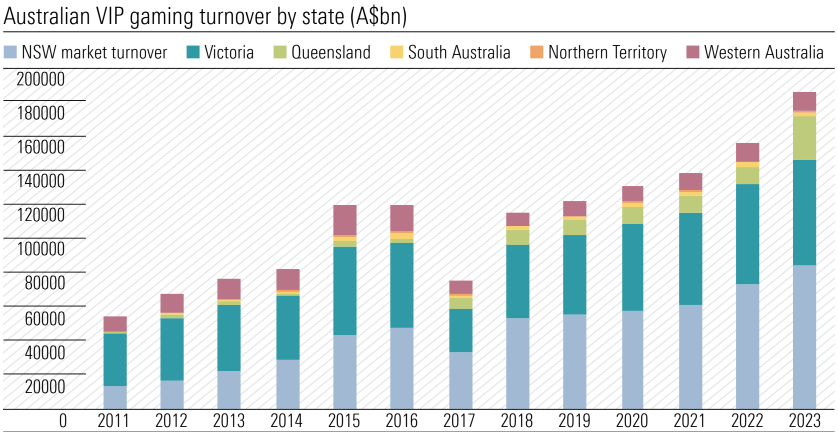
Most/Least Preferred Stocks

Crown Resorts is our preferred stock in the casino sector, trading at an attractive discount to our fair value estimate. We are attracted to the long-term outlook for the core Melbourne casino, and given the rebound in VIP turnover we are increasingly positive on the outlook for the Sydney casino, which will drive a meaningful earnings uplift from FY22 onwards. As the new casino hits its stride, we expect it represent approximately 20% of our earnings forecast and valuation.

Ainsworth remains attractively valued at the current price, although it remains a high-risk proposition. We believe continued expansion in North America, a gradual stabilisation in Australia, and benefits under Novomatic ownership are likely to drive the share price towards our fair value estimate. Aristocrat is a high-quality stock, and fairly valued at the current price, after enduring a vicious sell-off in recent months.

Whilst Tabcorp is only marginally undervalued at the current price, it offers investors an attractive 5% fully franked dividend yield. The additional contribution from the highly cash generative lotteries business should support growing dividend payments for the foreseeable future.

Exhibit 1: Ongoing recovery in VIP gaming to drive earnings growth for Crown Resorts
Australian VIP gaming turnover by state (A$bn)



Source: Company data, Morningstar estimates

Featured Recommendations (as at 12 Dec 2018)

	Recommendation	Moat Rating	Uncertainty Rating	Adj. EPS (cps) FY18A	Adj. EPS (cps) FY19F	EPS CAGR (%) 5yr	DPS (cps) FY18A	DPS (cps) FY19F	Franking FY18A (%)	PER (x) FY19F	Div.Yld (%) FY19F	Share Price ($)	Fair Value ($)	Price/Fair Value
Ainsworth Game Technology Ltd AGI	★★★★	Narrow	Very High	8.7	5.8	2.0%	4.0	2.3	100.0%	11.9	3.4%	0.68	1.20	0.57
Aristocrat Leisure Limited ALL	★★★	Narrow	High	114.1	135.0	12.4%	46.0	54.0	100.0%	16.2	2.5%	22.35	23.50	0.95
Crown Resorts Limited CWN	★★★★	Narrow	High	56.2	61.7	14.1%	60.0	60.0	65.0%	18.9	5.2%	11.81	15.00	0.79
Tabcorp Holdings Limited TAH	★★★	Narrow	Medium	16.6	22.5	16.8%	21.0	22.0	100.0%	18.7	5.2%	4.33	4.50	0.96

Retail

Cyclical clouds gathering over an expansive undercurrent of structural disruption

Johannes Faul, CFA
Director Equity Research, REITs, Retail

Earnings Outlook
Negative ↘

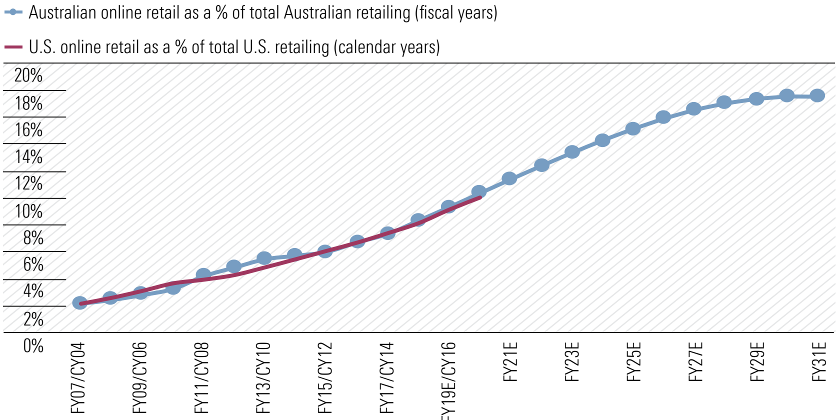
Valuation Outlook
Neutral →

Key Themes for 2018

We expect consumers to continue their migration from bricks-and-mortar to e-commerce. This trend continues to be the overarching structural challenge facing the retail industry globally, and Australia is no exception. We expect the impact on the listed retailers to vary. Retailers in categories more amenable to online shopping, such as consumer electronics, are more exposed to inroads made by online pure plays including Amazon.

We anticipate more store closures. Besides the investment required to build and strengthen online platforms, retailers are also confronted with declining foot-traffic weighing on store productivity. We expect most discretionary retailers are now at their peak footprint in terms of store count. Discount department store Target recently announced it is aiming to reduce its selling area by 20% over the next five years.

Exhibit 1: Australia's adoption of E-Commerce close on the heels of the U.S.



Source: U.S. Census Bureau, Australian Bureau of Statistics, National Australia Bank, Morningstar estimates

Unfortunately, in addition to the structural disruption from e-commerce, a cyclical storm is also brewing. We anticipate weakening housing markets in Sydney and Melbourne to crimp consumer confidence and restrain sales growth for discretionary retailers.

We don't expect EBIT margins of consumer staples retailers to rebound, with risk to the downside. For investors seeking exposure to the retail sector, grocers should be a safe place to hide from the above themes. Online penetration in food is only 2% in Australia and dominated by Woolworths and Coles. Further, spending on food was resilient during past economic slowdowns, including Australia's last recession in 1991 and the Global Financial Crisis in 2008/09. However, the supermarkets have problems of their own. Near term they must fend off Aldi's market grab, and in the medium-term hypermarket Kaufland and Amazon Fresh pose formidable new threats.

Most/Least Preferred Stocks

Our preferred picks in the retail sector are Coles Group and Myer. We expect Coles' food margins to stabilise at 4% and for it to offer income investors an annualised dividend yield of 5% at our $13.30 per share fair value estimate. And we expect Myer to improve its profitability, by closing loss-making stores and floor space as leases expire, and to successfully move more sales online.

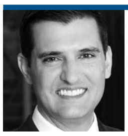
Woolworths and Premier Investments screen as overvalued. Woolworths' current share price implies a material, sustainable improvement in food EBIT margins--unlikely due to fierce competition. Premier's Smiggle brand is strong, but the drag from its core apparel brands is underappreciated. M

Featured Recommendations (as at 12 Dec 2018)

	Recommendation	Moat Rating	Uncertainty Rating	Adj. EPS (cps) FY18A	Adj. EPS (cps) FY19F	EPS CAGR (%) 5yr	DPS (cps) FY18A	DPS (cps) FY19F	Franking FY18A (%)	PER (x) FY19F	Div.Yld (%) FY19F	Share Price ($)	Fair Value ($)	Price/Fair Value
Coles Group Limited COL	★★★★	None	Low	70.4	75.2	4.3%	na	39.5	100.0%	16.5	3.2%	12.23	13.30	0.92
Myer Holdings Limited MYR	★★★★	None	High	4.0	3.4	13.6%	0.0	0.0	100.0%	11.5	0.0%	0.39	0.63	0.62
Premier Investments Limited PMV	★★★	None	Medium	74.3	81.1	11.0%	62.0	65.0	100.0%	19.1	4.2%	15.37	14.50	1.06
Woolworths Group Limited WOW	★★	Narrow	Medium	123.1	126.8	2.8%	93.0	101.0	100.0%	22.4	3.6%	28.47	24.50	1.16

Healthcare

Leading companies expanding globally, but short-term challenges present opportunity



Adam Fleck, CFA
Regional Director of Equity Research Australia & NZ

Mathew Hodge, CFA
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Angus Hewitt
Assoc. Equity Analyst

Earnings Outlook
Positive

Valuation Outlook
Positive

Key Themes for 2019

Drug Manufacturers and Biotechnology: Narrow-moat CSL should continue to grow revenues at high single digit rates underpinned by several new product releases and by focusing on future areas of unmet needs. We like the company's strategy, discipline and commitment to research and development.

Medical devices: We are optimistic on the outlook for the treatment of sleep apnoea, providing support for narrow-moat ResMed and Fisher & Paykel Healthcare. This market remains underpenetrated, with only around a third of sufferers in the U.S. diagnosed or receiving treatment, and even lower rates of treatment globally. Outside of apnoea, wide-moat Cochlear should be able to grow revenue at high single digit rates, underpinned by continued market penetration and upgrades for those with existing implants.

Healthcare providers: We continue to believe the long-term earnings outlook and competitive positions of narrow-moat hospital operators Ramsay Healthcare and Healthscope is good despite several short-term challenges such as declining private health insurance participation rates as the cost of healthcare has risen but the federal Labor Party's proposal to cap private health insurance premium growth at 2% could help. We continue to believe long-term earnings growth will be supported by population growth, the ageing population, rising demand for healthcare services, and economies of scale.

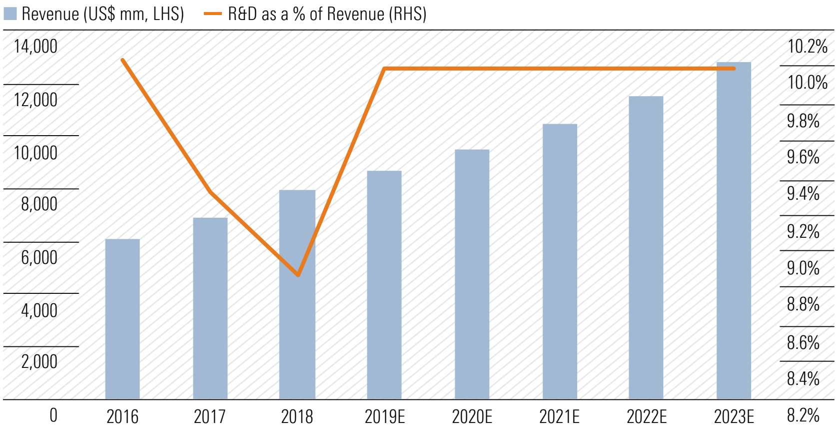
Medical distributors: The three listed pharmaceutical distributors, Ebos Group, Australian Pharmaceutical Industries and Sigma will continue to face a highly competitive landscape, with direct distribution by medicine manufacturers likely to be an added threat. This will be exacerbated by Chemist Warehouse's switching of wholesale supplier from Sigma to Ebos, for the bulk of its products from July 2019.

Most/Least Preferred Stocks

CSL trades at a discount, which we believe doesn't recognise its strong product pipeline focused around five key therapeutic areas in immunology, haematology, transplant, respiratory and cardiovascular, leveraging expertise in plasma fractionation and recombinant technology. Gene and cell therapy is another emerging area of proprietary knowledge.

Ramsay remains attractive, trading at a 15% discount to fair value. The company benefits from strong competitive positions including large market shares and associated cost advantages, and efficient scale benefits at some of its larger hospitals. Despite an increase in debt and potential integration challenges from its recent acquisition of European hospital group Capio, we forecast a solid underlying EPS CAGR of 7% over the next five years.

Exhibit 1: Increasing R&D spending should drive further revenue growth for CSL



Source: Company filings, Morningstar estimates

Featured Recommendations (as at 12 Dec 2018)

	Recommendation	Moat Rating	Uncertainty Rating	Adj. EPS (cps) FY18A	Adj. EPS (cps) FY19F	EPS CAGR (%) 5yr	DPS (cps) FY18A	DPS (cps) FY19F	Franking FY18A (%)	PER (x) FY19F	Div.Yld (%) FY19F	Share Price ($)	Fair Value ($)	Price/Fair Value
CSL Limited CSL	★★★★	Narrow	Medium	494.4	592.8	13.1%	222.5	272.8	0.0%	30.4	1.5%	182.70	207.00	0.88
Cochlear Limited COH	★★★	Wide	Medium	426.8	444.6	10.9%	300.0	311.2	100.0%	38.3	1.8%	170.44	180.00	0.95
Ramsay Health Care Limited RHC	★★★★	Narrow	Medium	279.9	284.0	7.2%	144.0	145.1	100.0%	18.8	2.7%	54.15	65.00	0.83

Building Materials & Other Industrials

Australian residential construction has peaked, but valuations look more reasonable

Grant Slade
Equity Analyst
Industrials

Adam Fleck, CFA
Regional Director of
Equity Research
Australia & NZ

Earnings Outlook
Negative ↘

Valuation Outlook
Positive ↗

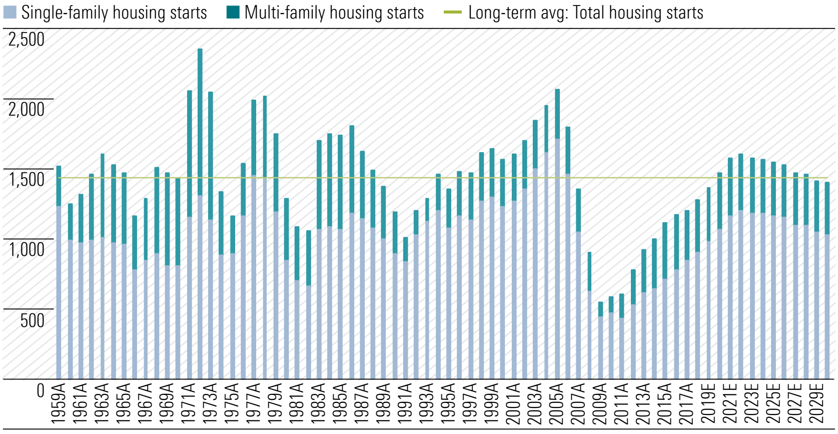
Key Themes for 2019

Australian residential construction activity reached a cyclical peak in 2018. Dwelling approvals eased through 2018, with approvals 14% lower year-on-year in October. Looking forward, we expect housing completions to fall by about 6% in FY19 with earnings across the building materials sector to track lower as a result.

Conversely, Australian infrastructure spending will remain strong, with a robust pipeline of projects nationally. Therefore, we anticipate sales volumes for infrastructure exposed names such as Adelaide Brighton and Boral to grow at circa 3% in 2019.

We remain optimistic regarding U.S. housing construction, despite slowing in late 2018. We forecast 1.37 million starts in 2019, peaking at 1.61 million starts in 2022.

Exhibit 1: U.S. housing construction set to normalise following lost decade



Source: U.S. Census Bureau New Construction Survey, Morningstar estimates

New Zealand experienced a record year for residential construction in 2018, with consents of approximately 33,000 for the year though to October 2018. We view 2018 as the cyclical peak for the housing market, however, and anticipate a decline of around 3% in consents in FY19.

Elsewhere, we see value emerging in packaging names under our coverage. Pact Group and Amcor will continue to benefit from the global economic expansion, despite the IMF's recent downgrade to its outlook for global growth. Population growth and rising per capita incomes, particularly in emerging markets, will drive continued top-line growth.

Most/Least Preferred Stocks

Narrow-moat James Hardie looks compelling. Tepid market share gains and softer-than-anticipated U.S. housing starts in 1H19 have led to share price weakness. The cyclical upswing in U.S. housing and a further 3% of market share gains will likely drive accelerated sales growth in the coming five years, however. Returns on invested capital will likely average a healthy 21% over said period.

Narrow-moat Pact Group is attractive, trading at a 30% discount to fair value. Resin price volatility pressured margins in 1Q19, but we expect this near-term headwind to abate. We view announced cost-out initiatives positively, with margins likely to improve over the medium-term as a result.

Orora remains the most overvalued stock within our building materials and other industrials coverage. Expectations for the magnitude of bolt-on acquisitions in North America remain significantly elevated and difficult to justify, in our view. M

Featured Recommendations (as at 12 Dec 2018)

	Recommendation	Moat Rating	Uncertainty Rating	Adj. EPS (cps) FY18A	Adj. EPS (cps) FY19F	EPS CAGR (%) 5yr	DPS (cps) FY18A	DPS (cps) FY19F	Franking FY18A (%)	PER (x) FY19F	Div.Yld (%) FY19F	Share Price ($)	Fair Value ($)	Price/Fair Value
Boral Limited BLD	★★★★	None	Medium	40.2	42.5	6.9%	26.5	29.8	50.0%	11.4	6.1%	4.99	6.30	0.79
James Hardie Industries JHX	★★★★	Narrow	Medium	94.7	94.0	11.4%	52.1	56.4	0.0%	16.2	3.7%	15.38	21.20	0.73
Orora ORA	★★	None	Medium	17.6	19.0	5.0%	12.5	13.3	30.0%	16.9	4.2%	3.23	2.50	1.29
Pact Group Holdings PGH	★★★★★	Narrow	Medium	26.5	26.2	3.9%	na	19.6	65.0%	12.5	6.0%	3.31	4.90	0.68

Travel, Leisure, Entertainment and Other Consumer

Impact of falling property prices on discretionary spending will be key swing factor

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Johannes Faul, CFA
Director Equity Research, REITs, Retail

Daniel Ragonese
Equity Analyst
Gaming, Consumer

Earnings Outlook
Negative

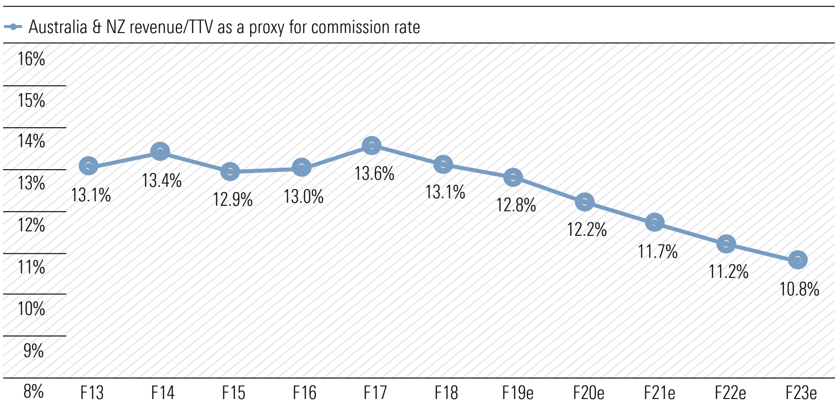
Valuation Outlook
Neutral

Key Themes for 2019

The wild card risk for the new year is cyclical, depending on the length and severity of the current downturn in house prices. A prolonged weakness in the housing market could sap consumer confidence and impact discretionary spending which ultimately drive the top-line of most companies operating in the travel, leisure, entertainment and other consumer sectors.

This, coupled with the possibility of a rising interest rate outlook and weak A$, paint a subdued 2019 picture. However, a one-size-fits-all view would not do justice to the eclectic mix of companies in this space. For instance, names such as InvoCare boasts defensive earnings qualities, while a recovery in sentiment on the Gold Coast theme parks (still suffering from the Dreamworld tragedy in October 2016) could be a material earnings growth driver for Village Roadshow and Ardent Leisure.

Exhibit 1: Structural pressure to manifest in commission rates for Flight Centre's ANZ business unit



Source: Company reports, Morningstar estimates

We see continued structural decline in carbonated soft-drink consumption given health concerns and container deposit programs, driving further negative volume performance for Coca-Cola Amatil. While we expect the company's Australian revenue to perform better given positive pricing from smaller package sizes and product mix shift, management's mid-single-digit earnings growth target again appears to be just out of reach. 2019 will likely be another transition year for the company.

Most/Least Preferred Stocks

InvoCare is our most preferred stock in the consumer sector, trading at an attractive 27% discount to our $16.00 per share valuation. In contrast to more cyclical consumer stocks, InvoCare's earnings are relatively immune to fluctuations in discretionary spending, and with the risk of housing price downturn. There are two factors weighing on the current share price, neither of which concern us. The ongoing refurbishment program which has disrupted operations, is temporary, and long-term will strengthen the competitive position and drive improved performance, meanwhile death rate has been unusually low, although this will revert to more normal levels.

Narrow-moat Domino's Pizza trades at an attractive discount to our $53 per share fair value estimate, offering an opportunity for long-term investors to gain exposure to a high-quality growth stock. Domino's growth profile is supported by a solid runway of new stores, strong online presence, continuous development of its digital platform, and strong brand recognition.

Flight Centre is our least preferred stock, trading at a 26% premium to our $38.00 per share fair value estimate. Structural headwinds buffeting the group's Australia and New Zealand division will continue, with Flight Centre's efforts to expand into corporate travel and overseas markets unable to offset. As such, we see the current trading multiples as still too high, despite our high regard for management's operating prowess. M

Featured Recommendations (as at 12 Dec 2018)

		Moat	Uncertainty	Adj. EPS (cps)		EPS CAGR	DPS (cps)		Franking	PER (x)	Div.Yld (%)	Share	Fair	Price/Fair
	Recommendation	Rating	Rating	FY18A	FY19F	(%) 5yr	FY18A	FY19F	FY18A (%)	FY19F	FY19F	Price ($)	Value ($)	Value
Domino's Pizza Enterprises DMP	★★★★	Narrow	Medium	152.4	181.1	17.6%	107.8	130.4	59.0%	23.9	3.0%	44.10	53.00	0.83
Flight Centre FLT	★★	None	High	280.2	278.6	-0.4%	167.0	167.0	100.0%	15.8	3.8%	44.27	38.00	1.17
Invocare IVC*	★★★★	Wide	Medium	50.4	53.9	4.5%	40.4	43.1	100.0%	20.6	3.9%	11.20	16.00	0.70

* December year end. FY18 is Morningstar forecast.

Transport and Transport Infrastructure

Ongoing economic expansion lays solid foundation for transports

Adrian Atkins
Senior Equity Analyst
Utilities, Transports

Adam Fleck, CFA
Regional Director of
Equity Research
Australia & NZ

Earnings Outlook

Positive ↗

Valuation Outlook

Neutral →

Key Themes for 2019

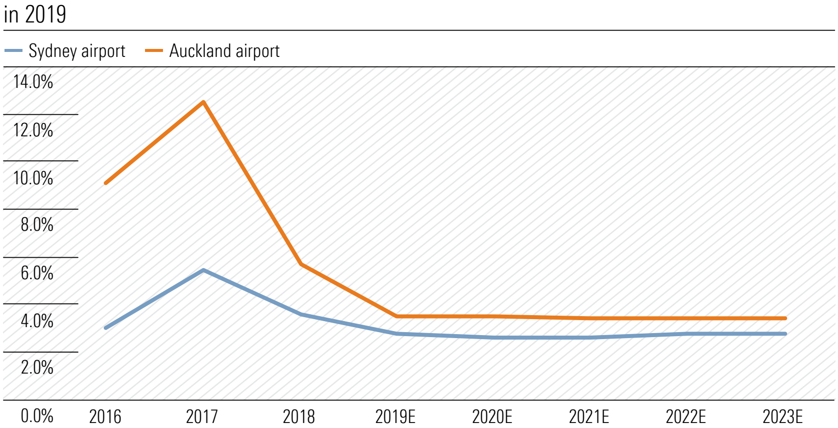
Transport should enjoy solid demand growth. Expectations for moderate GDP growth, mild inflation, low unemployment, population growth around 1.5% and rising foreign tourism suggest robust momentum in trade volumes and passenger transport will continue.

Logistics: Strength in the resources industry and containerised trade volumes point to solid earnings growth for Qube, particularly in the bulk and stevedoring businesses. Early warehouses and the import/export terminal at Moorebank will start operating in mid-2019, with the rest being developed progressively over several years. We are fans of the project, though caution ramp up in activity might be protracted. Aurizon's outlook is poor as tough regulation will hit rail network earnings from sometime in 2019. The haulage part of the business is performing better, but the huge exposure to the coal sector is a longer-term concern.

Airlines: Qantas faces some headwinds, as an almost 30% higher fuel bill bites into earnings. While ongoing cost cutting initiatives will help partially mitigate this pressure, the intense competitive environment will limit the ability to pass additional costs onto consumers.

Infrastructure: Both Sydney Airport and Auckland International Airport should see solid passenger traffic gains, following a similar trend from 2018, albeit at a slower pace given a lower rate of capacity additions. Maturing roads and pressure on disposable income are slowing Transurban's organic growth, while dilution from raising equity will see free cash flow fall short of distributions for a couple of years until new road projects complete. Mid-to-late-2019 will see the M4 East, 395 Express Lanes and NorthConnex open to traffic, bringing substantial new revenue.

Exhibit 1: Total passenger growth at Sydney and Auckland Airports will likely continue to slow in 2019



Sources: Company filings, Morningstar estimates Note: Sydney Airport on calendar year; Auckland on June fiscal year

Most/Least Preferred Stocks

Infrastructure stocks are looking better value with an average price/fair value of 1.0, after tracking sideways to down for the past couple of years, despite ongoing earnings and distribution growth. We marginally prefer narrow-moat Sydney Airport to wide-moat Auckland International Airport, based on current valuations. While we expect passenger growth to slow, we remain confident the airport will continue to enjoy gains well above population growth, alongside further retail spending benefits and expanding EBITDA margins over the long run. Wide-moat Transurban appears reasonable value.

Narrow-moat Qube is fairly-valued, while we remain cautious on Aurizon and the airlines.

Featured Recommendations (as at 12 Dec 2018)

	Recommendation	Moat Rating	Uncertainty Rating	Adj. EPS (cps) FY18A	Adj. EPS (cps) FY19F	EPS CAGR (%) 5yr	DPS (cps) FY18A	DPS (cps) FY19F	Franking FY18A (%)	PER (x) FY19F	Div.Yld (%) FY19F	Share Price ($)	Fair Value ($)	Price/Fair Value
Auckland Int. Airport AIA-NZ*	★★★	Wide	Medium	22.0	23.1	2.6%	21.5	23.1	100.0%	30.2	3.3%	6.99	7.40	0.94
Qube Holdings Limited QUB	★★★	Narrow	Medium	6.7	7.6	5.5%	7.5	5.5	100.0%	34.6	2.1%	2.61	2.55	1.02
Sydney Airport SYD**	★★★	Narrow	Medium	17.6	19.1	12.8%	37.5	38.7	0.0%	37.4	5.4%	7.04	7.30	0.96
Transurban Group TCL	★★★	Wide	Medium	22.7	23.1	3.4%	56.0	59.0	8.9%	51.3	5.0%	11.93	11.00	1.08

* Dividends for Auckland International Airport are fully imputed for New Zealand residents. Australian investors receive supplementary dividends. Figures in NZD.

** December year end. FY18 is Morningstar forecast.

Utilities

Headwinds remain but at least shares are cheaper

Adrian Atkins
Senior Equity Analyst
Utilities, Transports

Earnings Outlook
Neutral →

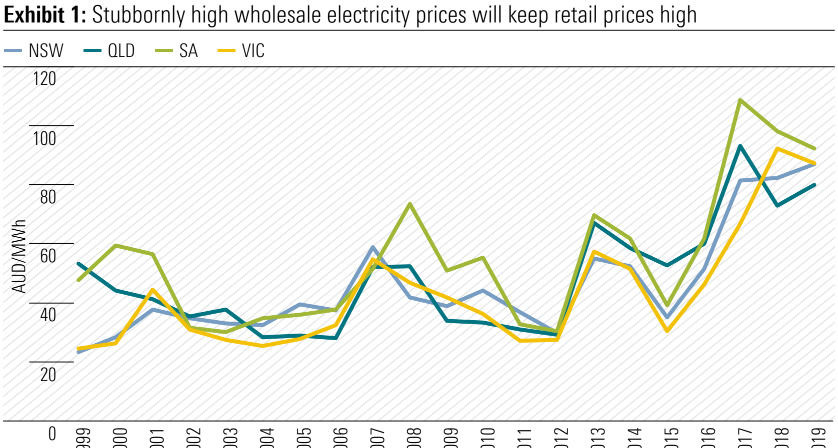
Valuation Outlook
Neutral →

Key Themes for 2019

The key headwinds of rising bond yields as central banks normalise monetary policy and regulatory attacks to improve utility bill affordability will continue over the long term. But it's not all bad news with utility share prices better value after some major falls. Given the political attention on electricity prices, expect the 2019 Federal election to create uncertainty and volatility for utilities.

Australian Generation/Retailing: Earnings growth is petering out as governments try to protect households and businesses from expensive electricity bills. But the degree to which governments can reduce retail prices is limited by stubbornly high wholesale electricity prices. AGL Energy is likely to report flat earnings. Of more interest will be what it does with its balance sheet capacity; an acquisition or a special dividend is likely in 2019. Origin Energy's utility division also faces earnings headwinds, but this should be offset by stronger earnings from its part-owned LNG export business, assuming oil prices hold up.

Exhibit 1: Stubbornly high wholesale electricity prices will keep retail prices high



Source: Australian Energy Market Operator

New Zealand Generation/Retailing: Conditions in New Zealand are relatively stable, besides the normal vagaries of weather. Unlike Australia, the industry is largely well positioned for climate change and that's good for the incumbents. New Zealand's electricity is 80% renewable--mostly flexible hydroelectricity and reliable geothermal power, which we consider much better than Australia's main renewable options of intermittent wind and solar power. Further, retail prices are cheaper than in Australia, suggesting less regulatory risk.

Distribution/Transmission: Returns for regulated electricity and gas network owners AusNet Services and Spark Infrastructure have probably bottomed, suggesting earnings should strengthen over the medium term on investment to upgrade and extend the networks. In contrast, returns for the mostly unregulated APA Group should start trending lower as gas market reform weakens its bargaining position. However, a takeover from a domestic consortium is possible after the Treasurer blocked Cheung Kong's $13bn approach.

Most/Least Preferred Stocks

Utilities are fairly valued with an average price/fair value of 0.98. Attractive yields, defensive earnings and modest growth are on offer across the sector. We generally prefer the New Zealand utilities given a more stable long-term industry outlook. In Australia, we lean towards AGL and AusNet. The volatile oil price and high financial leverage are our main concerns with Origin, but it's much cheaper than six months ago.

Featured Recommendations (as at 12 Dec 2018)

	Recommendation	Moat Rating	Uncertainty Rating	Adj. EPS (cps) FY18A	Adj. EPS (cps) FY19F	EPS CAGR (%) 5yr	DPS (cps) FY18A	DPS (cps) FY19F	Franking FY18A (%)	PER (x) FY19F	Div.Yld (%) FY19F	Share Price ($)	Fair Value ($)	Price/Fair Value
AGL Energy Limited AGL	★★★	Narrow	Medium	156.0	154.6	-2.1%	117.0	117.0	80.0%	12.5	6.1%	19.57	20.00	0.98
APA Group APA	★★★	Narrow	Medium	23.3	24.1	10.0%	45.5	46.5	14.0%	36.6	5.3%	8.91	8.30	1.07
AusNet Services AST	★★★	None	Medium	6.6	5.9	0.6%	9.3	9.7	0.0%	26.8	6.1%	1.62	1.65	0.98
Contact Energy Limited CEN-NZ*	★★★	Narrow	Medium	18.2	26.7	5.0%	32.0	35.0	100.0%	22.0	6.0%	5.92	6.20	0.95
Mercury NZ Limited MCY-NZ*	★★★	Narrow	Medium	14.4	12.8	1.5%	15.1	15.5	100.0%	27.9	4.3%	3.59	3.60	1.00

* Dividends for Contact Energy and Mercury are imputed for New Zealand residents only. Figures in NZD.

Metals and Mining

Chinese investment, trade and interest rate risks to weigh on commodities in 2019

Mathew Hodge, CFA
Senior Equity Analyst
Resources

Earnings Outlook
Negative ↘

Valuation Outlook
Negative ↘

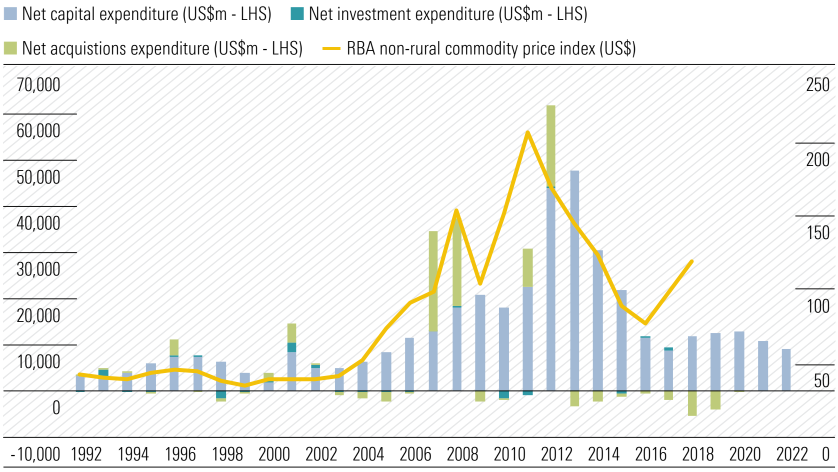
Key Themes for 2019

We expect commodity prices and earnings for the miners to generally decline through 2019 and beyond. The demand boost from high levels of investment in China started to wane in the second half of 2018 and we expect this to continue as debt growth slows from unsustainable levels. We are late into the global economic upcycle and see risks from rising interest rates and tariffs.

The ASX 200 resources index has sold off nearly 15% since its early October peak, driven by lower commodity prices, particularly oil and base metals. Bulk commodities – especially iron ore and metallurgical coal – have proven more resilient, supported by buoyant steel spreads. More recently steel spreads have contracted, suggesting potential demand weakness.

Exhibit 1: History suggests the favourable combination of high commodity prices and low capital expenditure is unlikely to last

Inflation adjusted capital expenditure for BHP, Rio Tinto and Fortescue versus the RBA non-rural commodity price index



Source: Company reports, World Bank, RBA, Morningstar forecasts

Despite the general commodity sell-off, prices for iron ore, coking coal, alumina and thermal coal remain elevated. Producer margins generally remain high and above midcycle levels.

Returns on invested capital are generally high across the industry, which we think is likely to incentivise new supply given the limited barriers to entry to build new mines. Rio Tinto's earnings, for example, are close to 2012-13 levels typical of the China boom heights.

Chinese government policy will be important, especially, where China is a substantial supplier such as for coal, steel, and aluminium. Production cuts have supported near-term margins in those industries, but overcapacity remains, and new supply is being added, particularly for coal.

The recent normalisation of steel margins is driving a contraction in the discounts and premiums for low- and high-grade iron ore. Lower margins shift the focus of steelmakers to minimising input costs rather than maximising production, a relative benefit for Fortescue over BHP and Rio Tinto.

Most/Least Preferred Stocks

First half 2018 saw markets unperturbed by risks from rising interest rates and tariffs. But the recent sell-off, sees generally less overvaluation, particularly among the base metal miners. The bulk commodity producers are generally most overvalued given still-high prices.

Iluka and Newcrest represent the best value in the sector, trading at 10% and 26% discounts to our fair value estimates respectively. Iluka is exposed to late cycle commodities in zircon and titanium dioxide feedstocks. We think future industry supply is challenged, particularly for zircon, which should support prices. Newcrest should benefit from growing gold demand in India and China.

Of the majors, we prefer BHP to Rio Tinto given BHP's exposure to oil and Rio Tinto's reliance on still-high iron ore prices. Fortescue is nearly fairly valued on concerns over low-quality discounts.

Featured Recommendations (as at 12 Dec 2018)

	Recommendation	Moat Rating	Uncertainty Rating	Adj. EPS (cps) FY18A	Adj. EPS (cps) FY19F	EPS CAGR (%) 5yr	DPS (cps) FY18A	DPS (cps) FY19F	Franking FY18A (%)	PER (x) FY19F	Div.Yld (%) FY19F	Share Price ($)	Fair Value ($)	Price/Fair Value
BHP Billiton Limited BHP	★★	None	High	216.5	260.5	-4.4%	152.7	168.9	100.0%	12.2	5.3%	32.19	25.00	1.29
Iluka Resources Limited ILU*	★★★★	None	High	56.8	91.6	26.8%	20.0	30.0	100.0%	8.3	3.9%	7.53	10.50	0.72
Newcrest Mining Limited NCM	★★★	None	High	61.8	101.3	10.0%	24.8	30.0	100.0%	20.8	1.4%	20.95	23.00	0.91
Rio Tinto Limited RIO*	★★	None	High	797.2	637.8	-6.2%	472.1	450.7	100.0%	11.4	6.2%	74.10	52.00	1.43

* December year end. FY18 is Morningstar forecast.

Energy

Midcycle US$60 Brent unchanged and China gas outlook favourable

Mark Taylor
Senior Equity Analyst
Energy and
Mining Services

Earnings Outlook
Negative ↘

Valuation Outlook
Positive ↗

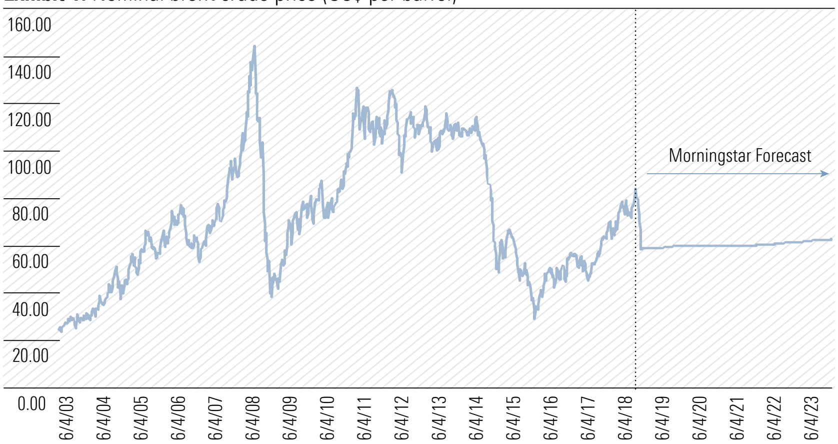
Key Themes for 2019

Our midcycle oil price forecast of US$60 per barrel Brent remains intact, determined by the break-even cost for U.S. shale, the marginal producer in our framework. U.S. shale costs can support higher activity without materially lower break-evens, thanks to abundant service capacity and decades of highly productive Tier 1 inventory. The Brent crude price has fallen 30% from US$86 September highs, and at just below US$60 is back in line with our midcycle forecast.

More importantly for Australian energy companies, our China natural gas consumption and LNG import forecasts have increased significantly. We now expect China gas consumption of 329 billion cubic metres (bcm) in 2020 versus our earlier expectations of 290 bcm, and LNG imports of 114 bcm compared with prior expectations of 75 bcm. China's goals to address environmental concerns are powerful drivers for long-term gas and LNG demand, especially since domestic natural gas production cannot meet the country's consumption needs. The country's natural gas production is unlikely to repeat the success of the shale revolution in the U.S. China's current five-year plan calls for natural gas to increase as a percentage of overall energy mix from 7% in 2017 to 15% by 2030.

We predict the LNG infrastructure necessary to support our demand forecast will be in place both within China and globally. We forecast surging Chinese LNG imports growing at a robust 14% compound annual growth rate from 2018 to 2028. In addition to the supply gap, a lack of natural gas storage capacity, the inability of pipeline imports to respond effectively to demand changes, and the lack of a fully liberalised market for pricing gas will support LNG growth. Our midcycle LNG price estimate of US$8.50/mmbtu is based on the price needed for the marginal project to be constructed, which we view as being greenfield U.S. developments.

Exhibit 1: Nominal brent crude price (US$ per barrel)



Source: Morningstar forecasts

Most/Least Preferred Stocks

The Australian energy sector offers attractive value at current levels. We think the sharp pull-back in sympathy with a weaker Brent price unwarranted. Australian energy companies are most levered to natural gas and LNG prices where the demand outlook is more favourable than for crude. While Asia LNG prices are for now still substantially tied to crude prices, growth in gas markets will increasingly encourage pricing based on gas fundamentals, including in spot pricing.

Woodside is the cheapest of the three largest local names, though Santos also appeals with an attractive valuation. Oil Search remains overvalued, given the heavy PNG sovereign risk premium we apply. At the smaller end, Beach Energy trades at a sizeable discount to fair value.

Featured Recommendations (as at 12 Dec 2018)

	Recommendation	Moat Rating	Uncertainty Rating	Adj. EPS (cps) FY18A	Adj. EPS (cps) FY19F	EPS CAGR (%) 5yr	DPS (cps) FY18A	DPS (cps) FY19F	Franking FY18A (%)	PER (x) FY19F	Div.Yld (%) FY19F	Share Price ($)	Fair Value ($)	Price/Fair Value
Beach Energy Limited BPT	★★★★	None	High	13.2	13.5	-0.4%	2.0	2.0	100.0%	10.8	1.4%	1.49	1.80	0.83
Oil Search Limited OSH*	★★★	None	High	30.9	57.2	10.8%	14.7	28.6	0.0%	12.7	4.0%	7.38	6.60	1.12
Santos Limited STO*	★★★★	None	High	43.0	82.9	20.4%	11.8	20.0	100.0%	6.8	3.5%	5.69	7.85	0.72
Woodside Petroleum Limited WPL*	★★★★	None	High	213.9	323.3	3.5%	176.0	258.7	100.0%	9.6	8.4%	31.61	46.50	0.68

* December year end. FY18 is Morningstar forecast.

Mining Services

Infrastructure spending as good as it gets

Mark Taylor
Senior Equity Analyst
Energy and
Mining Services

Earnings Outlook
Positive ↗

Valuation Outlook
Negative ↘

Key Themes for 2019

Excluding Australian energy infrastructure spending, which is expected to plunge dramatically in 2019 as the tail end of the LNG construction boom completes, we project modest increases in infrastructure expenditure to 2022. The low point was in 2017 and most Mining Services company earnings have improved since then. The drivers of improvement are rising mining expenditure from cyclically low levels and strong public infrastructure expenditure including on road and rail. We also expect ongoing growth in maintenance expenditure (much LNG driven), though from a considerably less material position.

Private participation in public infrastructure expenditure has been increasing. But with now 70% public infrastructure accounted for by private contractors, up from around 40% just over a decade ago, we think this trend has substantially played out. Further, weakening public infrastructure expenditure from anticipated 2019 peaks is expected to be a partial offset to expenditure overall.

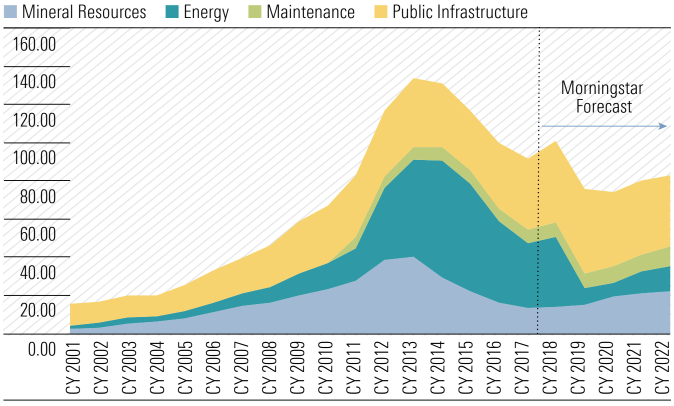
For the Mining Services companies we cover, we project only limited single digit 5-year revenue CAGR. Last actual half-on-half earnings improvement was largely revenue-driven. But most the modest average 3.5% five-year EBITDA CAGR we project going forward is margin driven. We credit an average 5%-10% improvement in midcycle EBITDA margins, driven by cost cutting and efficiencies, and catch-up expenditure by mining companies which postponed work during the post-boom commodities decline. Commodity prices have recovered though we project price declines from here, including a 40% decline in iron ore price from US$65 per tonne to our mid-cycle US$38 in 2021 dollars.

Most/Least Preferred Stocks

Despite sharp share price pull-backs recently, the Australian Mining Services sector remains on average materially overvalued. Least overvalued are explosives provider Orica and industrial equipment conglomerate Seven Group Limited. Orica can expect comparative commodity price demand inelasticity for its products, but with margin exposure. Seven Group has delivered excellent returns for shareholders over the long run and earnings visibility is improving.

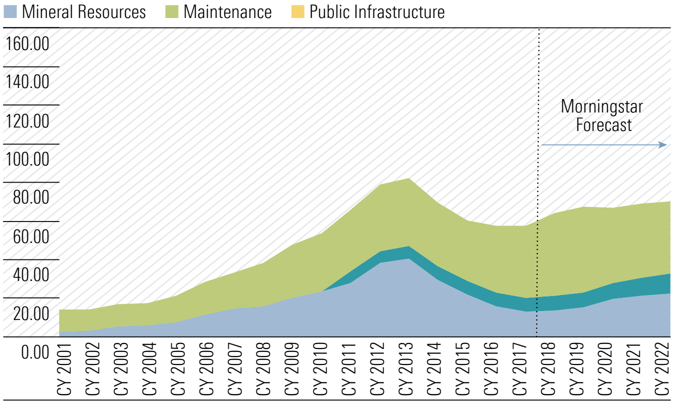
Most over-valued are ALS Limited followed by WorleyParsons. We think the market overestimates growth potential in engineering services for WorleyParsons, and from geochemical sampling and environmental and pharmaceutical testing for ALS Limited.

Exhibit 1: Infrastructure Spending (A$bn)



Source: BIS Oxford Economics as at April 2018

Exhibit 2: Infrastructure spending excluding energy (A$bn)



Source: BIS Oxford Economics as at April 2018

Featured Recommendations (as at 12 Dec 2018)

	Recommendation	Moat Rating	Uncertainty Rating	Adj. EPS (cps) FY18A	Adj. EPS (cps) FY19F	EPS CAGR (%) 5yr	DPS (cps) FY18A	DPS (cps) FY19F	Franking FY18A (%)	PER (x) FY19F	Div.Yld (%) FY19F	Share Price ($)	Fair Value ($)	Price/Fair Value
ALS Limited ALQ	★	None	High	25.3	36.2	8.5%	17.0	21.6	17.0%	19.3	3.1%	7.12	3.85	1.85
Orica Limited ORI	★★★	None	High	85.7	110.8	17.1%	51.5	55.3	0.0%	15.2	3.3%	17.19	16.50	1.04
Seven Group Holdings SVW	★★★	None	High	97.2	110.4	6.8%	42.0	55.2	100.0%	12.8	3.9%	14.03	15.00	0.94
WorleyParsons Limited WOR	★★	None	High	59.9	70.1	9.9%	25.0	42.1	0.0%	17.7	3.4%	12.50	9.00	1.39

Hybrids

Political uncertainty clouds 2019 hybrid outlook

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Key Themes for 2019

Regulatory risks loom large: Regulatory risk jumps to the forefront of hybrid risks in 2019, due largely to Labor's proposed franking credit policy, which threatens to remove surplus cash rebates from a significant proportion of the hybrid market. Our calculations suggest this could impact between 15% and 25% of outstanding issuance, likely driving a price fall if implemented. We believe hybrids have the most to lose from this initiative given their unfranked return will resemble investments much higher on the capital structure, such as senior unsecured bonds. Regardless, we expect pricing to adjust to a new equilibrium as new buyers enter the market.

Another year of tight supply to support pricing: Another year of low supply is expected. The investable universe will continue to become further concentrated in financial services as corporate issuers continue to withdraw from the hybrid market in preference for cheaper funding. As issuers redeem, we expect large proportions of that money to flow back into the hybrid market, supporting spreads. Following AMP's recent hybrid redemption, we also expect AGL Energy and Tatts Group to redeem their notes. Meanwhile, we anticipate National Australia Bank will roll their NAB Convertible Preference Shares (NABPA) into a new hybrid security as will Insurance Australia Group with their IANG Reset Exchange Securities (IANG) which are due for first call in December 2019.

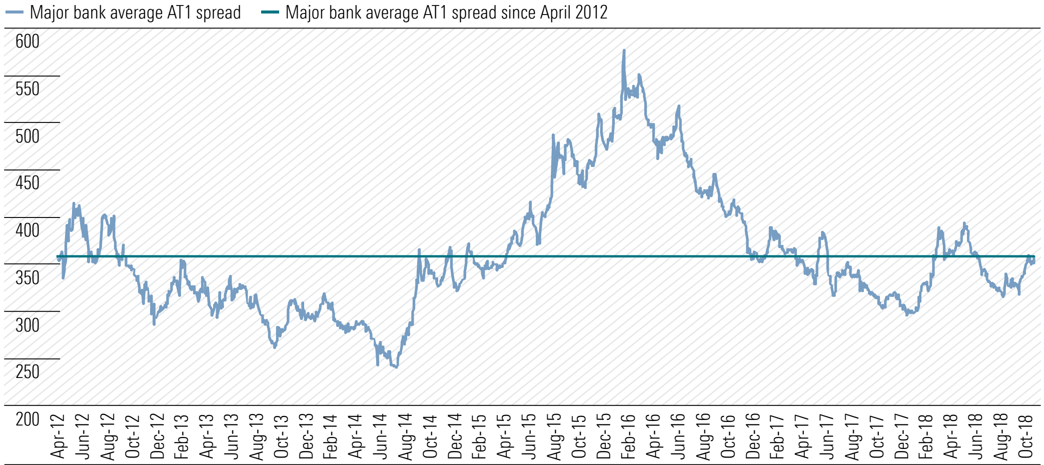
APRA initiatives could lead to increased Tier-2 supply for retail investors: Still in discussion phase, recently released APRA discussion papers have proposed an option which could lead to significantly large amounts of Tier-2 issuance by the major banks. Tier-2 sits higher up the capital structure than Tier-1 securities. For example, NAB Subordinated Notes 2 (NABPE) are an example of a Tier-2 security. With no final decisions due until early to mid-2019, at best we could see some Tier-2 issuance in the second half of the calendar year. This would be a fantastic addition to the suite of investable products for the retail client, particularly given the more traditional fixed income characteristics that come with Tier-2 securities.

Be patient, opportunities will present themselves: A global backdrop of increased market volatility, the Royal Commission fallout, the potential for an incoming Labor government and the headwinds facing banking profitability all present real risks to hybrid pricing. However, the continued resilience of the domestic economy as well as the continued strength of major bank profitability and capital positioning should provide a floor to price weakness. Our preference is to remain weighted towards shorter-dated hybrid securities, given the flatness of the curve.

Most/Least Preferred Hybrids

Assuming clients can utilise franking credits, our preferred hybrid securities are the ANZ Capital Notes 2 (ANZPE), the Macquarie Group Capital Notes 2 (MQGPB) and the Ramsay CARES (RHCPA). M

Exhibit 1: Hybrids spreads are expected to trend upwards in 2019



Source: Morningstar