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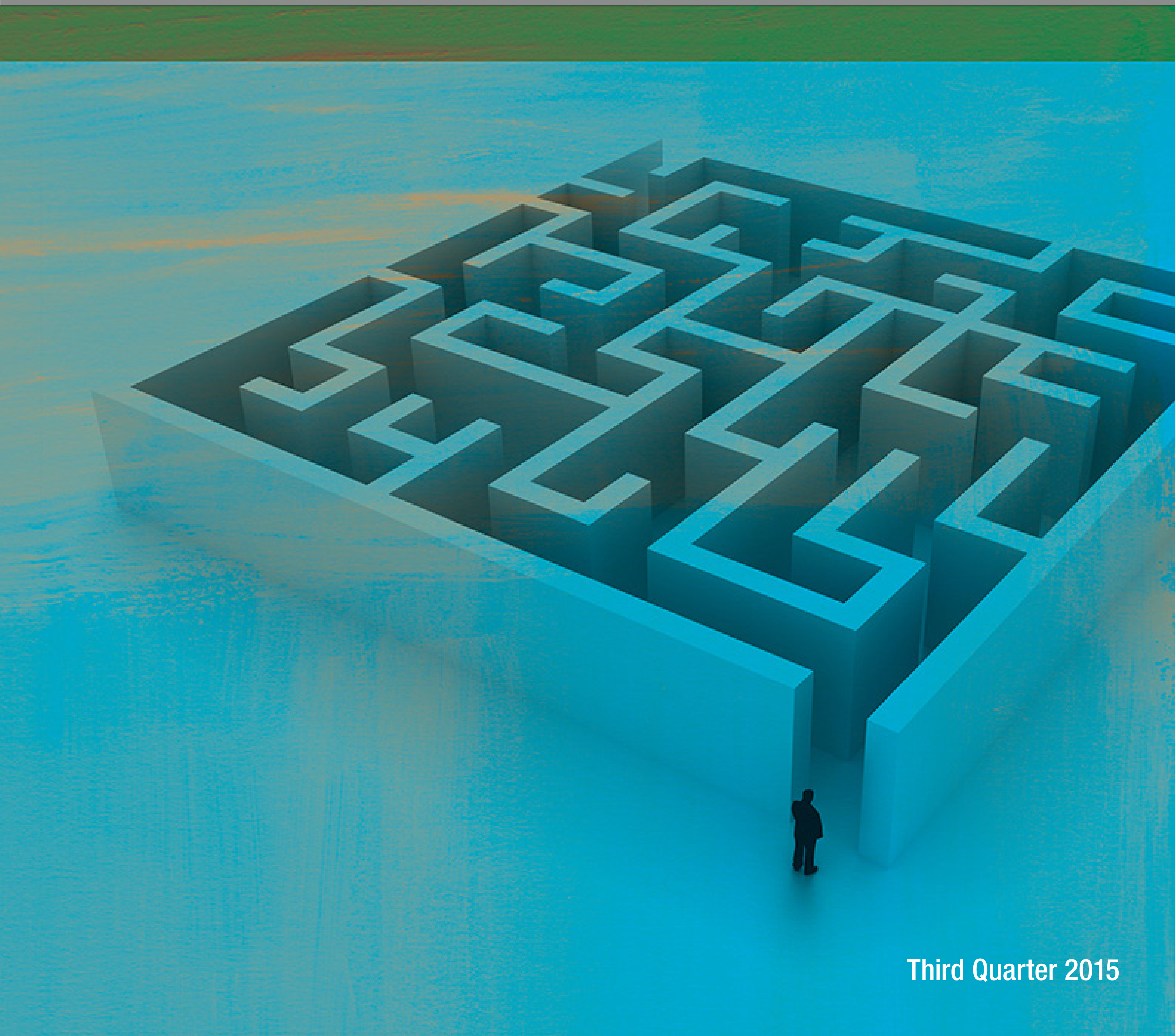
Investment Strategy



Third Quarter 2015

Economic Outlook

Greek debt default – Expect the shock to be short lived

Dominating current headlines is the Greek debt default which has generated a bull market correction in Australia and a more modest pullback in the US.

As we go to print the Greek banks remain closed with negotiations scheduled to continue with the Eurogroup. In a release made prior to the referendum, the IMF has determined that Greek sovereign debt is no longer sustainable. Their optimistic assumptions on Greek growth and Greek privatisation receipts made in their earlier reports have not come to pass. They suggest that ‘haircuts’ or debt forgiveness of up to 30% of GDP may be necessary. This could be combined with the extension of the grace period to 20 years before making any debt repayment. The total debt repayment period might then be extended to 40 years. These concessions, together with others, may now have to be made by the Eurogroup in order to keep Greece in the Euro Area. Events are moving quickly and we believe that markets will react positively to decisive action on this front whether Greece remains in the Euro Area or not. Obviously the exit scenario would prolong the uncertainty.

We don’t believe that the events in Greece will trigger a sovereign debt crisis similar to 2012. The reason is that Greek debt is now no longer widely held by European Banks. Instead, Greek debt is primarily held by institutions associated with the Eurogroup as well as by the IMF. These institutions are capable of being recapitalised by their member countries. The political effect of Greece crashing out of the Euro Area this way is far more significant.

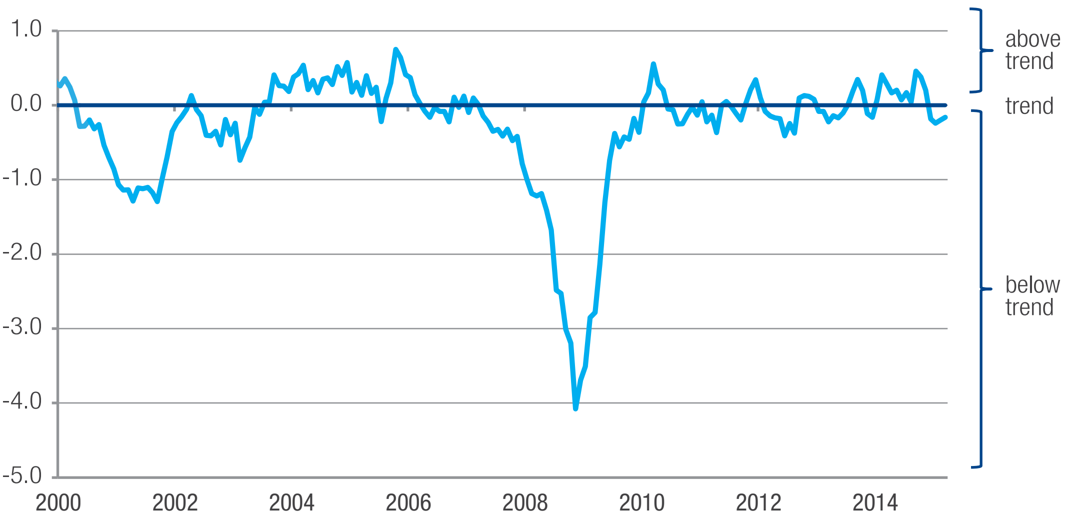
Ultimately we think the current shock to the stock market will be short lived. The shock to the structure and the credibility of the European Union however will live for many years.

US strong – Weak 1Q should prove to be an aberration

The US economy endured a weak first quarter with GDP falling by 0.2% (annualised) contrasting with the 2.2% growth enjoyed in the fourth quarter of 2014.

Initially, the first quarter decline was thought to be a result of another cold winter in the north-east. Closer examination suggests however that the major cause was a decline in non-residential construction associated with the petroleum sector. The slump resulted from a fall in investment by oil companies following the collapse in the oil price. We expect this weak level of investment in the petroleum sector to be sustained in the second quarter gradually recovering to near positive territory by the end of 2015.

The Chicago Fed National Activity Index confirms that US economic growth is steadily trending upwards.



Source: Chicagofed.org, Morgans

At the same time the US has seen a resurgence in technology investment, in particular increases in investment in computers and peripherals. Firms are investing in more computer equipment so they can hire more staff in the services sector. Residential investment should also accelerate in the second quarter and again in the third quarter.

Accordingly we expect US GDP growth to steadily accelerate from -0.2% in the first quarter to a positive 2.1% in the second quarter, 3% in the third and 3.1% in the fourth quarter of 2015. These high rates of growth should then be sustained through 2016. The result should be a full year growth rate of 2.1% for the US economy for 2015 followed by an acceleration to 3.1% for 2016.

Australia – Forecasting flat growth

In his speech to the Economic Society of Australia (QLD) in Brisbane on 10 June, Reserve Bank Governor Stevens said that the Australian economy was growing at just shy of 2.5% with underlying inflation between 2.25% and 2.5%. He said that recent growth in the Australian economy has not been as strong as required to offset the decline in mining investment.

He noted that we are witnessing a lengthy adjustment to both a once in a century cycle in our terms of trade and the earlier increase in household leverage. During the late 1990s and early 2000s, very confident households spent and borrowed more and in the process extended their balance sheets. That process started to fade in 2006 and then finished abruptly when the financial crisis hit.

He said by that time, a run up in resource prices was imparting a very large stimulus to the economy and allowing for solid growth to continue at a time when most other countries were feeling the aftermath of the financial crisis. By now most of the capital spending that was needed to lift the output of the mining sector has been completed at least for the production of iron ore. Some very large LNG projects are still underway but as those projects draw to a close, the decline in mining investment that is already underway will perhaps accelerate.

Looking ahead, Stevens thinks the most recent forecasts suggest that growth rates will be similar to those we have observed recently. Residential investment will reach new highs over the period ahead. Household consumption is expected to record modest growth. With national income growth reduced by a fall in terms of trade, this requires a modest decline in the savings rate. Putting all that together he said, the economy could do with some more demand growth over the next couple of years. He left the audience with the profound impression that could involve some further rate cuts by the RBA. We continue to forecast another 1 or 2 rate cuts in the current interest rate cycle, primarily to combat upward pressure in unemployment.

Stock market – Aussie market in the Buy zone

Markets are navigating a period of flat earnings growth for both US and Australian companies. However both markets are trading at modest price to earnings multiple premiums to their long term averages which usually implies that investors are optimistic that earnings will grow. This may be partially true, however the over-riding driver is the ultra-low interest (and bond rate) environment forcing funds into equities to earn a tangible return.

We peg fair value of the US S&P500 at 1,800 points, rising to 1,900 points by December 2015.

Watch Chief Economist **Michael Knox** outline his thoughts on the events unfolding in Greece and their implications for markets at **http://www.morgans.com.au/Blog/2015/July/Why-the-Eurogroup-is-wrong.aspx**

This suggests the US market is still modestly overvalued trading above both of these levels. We peg fair value of the ASX200 at 5,600 points, rising to 5,700 points by December 2015. As we go to print, the market looks slightly (<5%) cheap.

It's quite possible that a prolonged resolution to the Greek crisis could push both markets lower in the immediate term. That said, as stated above we expect the shock to the stock market to be short lived.

We don't believe that the events in Greece will trigger a sovereign debt crisis similar to 2012.

Australian Economic forecasts – End of 2015

	Morgans view	Market view
GDP Growth	2.7%	2.5%
Inflation	2.5%	1.8%
RBA Cash rate	1.75%-1.50%	2.00%
Aussie Dollar	0.72 USc	0.74 USc
ASX200 Index	5689	5800

Source: Bloomberg, Morgans

Asset Allocation

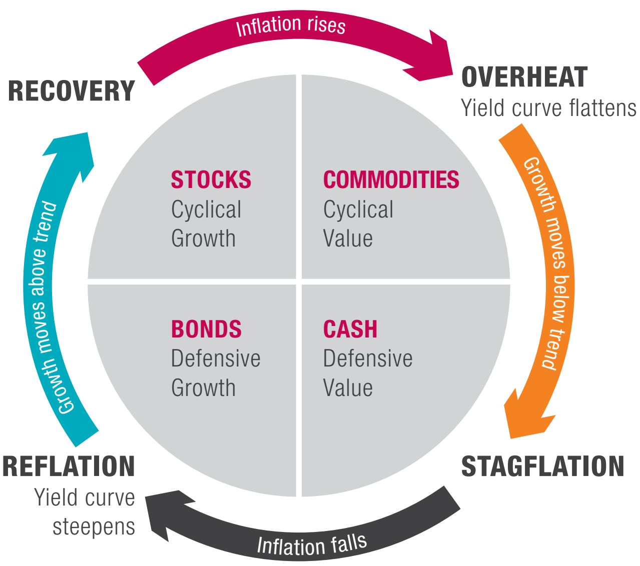
Asset allocation explained

Strategic Asset Allocation (SAA) is the process of allocating funds between asset classes to optimise investors' return objectives and risk tolerance with long-run capital market expectations. It is perhaps the most important, but one of the most overlooked aspects of wealth management.

The essence of SAA is diversification. Spreading investments across different types of assets can smooth out higher and lower return variations that occur through the economic cycle. This balances long-term return and risk objectives.

The asset classes

The four main asset classes are Equities (shares), Income Assets, Property and Cash. Within Income Assets we include Listed Income Securities (hybrids), Government Bonds, Corporate Bonds and Term Deposits. SAA simply provides a framework for how they should be integrated within portfolios.



Source: Fidelity, Morgans

Morgans approach explained

Morgans takes a systematic approach to SAA. We first determine where investing conditions sit within the economic cycle with respect to the relative attractiveness of each asset class. We then apply recommended longer term benchmark allocations per asset class. Within portfolios, actual allocations have scope to vary by up to 10-15% around benchmark allocations. These 'Tactical Tilts' represent an investing bias generated by shorter term drivers. Here we take into account:

- The economic cycle
- Key forecasts for growth, interest rates and inflation, and
- Risks to these forecasts.

Morgans reviews its SAA settings quarterly in conjunction with Investment Strategy, thus ensuring a stable risk profile.

The economic cycle

We find it useful to reference the economic cycle when explaining our approach. Fidelity's well known 'Investment Clock' separates the economic cycle into four phases based on the strength of economic growth and inflation. This illustrates the relative attractiveness of various asset classes, which tend to outperform others at various stages of the economic cycle. We use this as a guide only and note that not all phases of each economic cycle are the same.

No time for complacency

We expect markets to err on the side of caution over the next few months, not withstanding episodes of optimism on any resolution in Europe and elsewhere. Optimism is steadily building in the US but it remains one of the only bright spots. We expect the US to begin the process of interest rate normalisation at some time this year but we're not confident if this change in course can be accomplished without disruption to financial markets. We see a combination of unusually low yields on financial assets, compressed risk premia and diverging outlooks for monetary policy across the major jurisdictions. This paints a complex picture for investors over the next 12 months. We will be closely monitoring:

- **Macro tail risks:** Resolution of the Greek debt crisis – markets will continue to discount unless a decisive outcome is achieved one way or another.
- **US rates lift off**: Improving data from the US may prompt a September move in interest rates, watch for sustained improvements in the job market, inflation and manufacturing data.
- **Domestic Earnings growth and confidence:** Business and consumer confidence have failed to reignite which will temper earnings expectations. Watch for improving confidence particularly capex and hiring intentions.

Over the last month volatility has once again reasserted itself into markets with bond and equity markets changing courses frequently and rapidly. Though we see value emerging our core investment strategy remains unchanged and we highlight the need for investors to remain cautious.

Recommended asset allocations and active tilts

The recovery stage of the economic cycle is supportive of reducing allocations to defensive class assets such as bonds and into cyclical growth through equities. It is increasingly clear that there is little return in many fixed income markets because of central bank policies in mopping up assets by deliberately targeting inflation. In this environment, we think it is more appropriate to add to equities, by accessing either companies benefiting from structural long term growth trends or to gain exposures to sustainable dividend income, while accumulating small positions in early stage cyclical stocks in retail, technology and industrials.

At an index level the equity market has reversed most of its gains over the past two years but we caution against treating it as an outright buying opportunity. The earnings recovery is in its infancy and uneven so our preference is to selectively increase our active weight in Equities through stock selection and lift our cash balance until we see signs of a much broader based earnings recovery.

US data continues to point to a firmer recovery and expectations of the first interest rate rise in nearly 9 years by the end of 2015 should see a gradual rotation away from the property sector. If the trajectory of the circa-200,000 jobs created in the US each month can be sustained, we see the very real risk of inflation taking hold much more rapidly than the market currently appreciates and thereby forcing the US Central Banks' hand in lifting interest rates. The property sector outperformed all others in 2014 and we think at this point in the cycle the risk/reward profile is skewed to the downside so we introduce a negative active tilt this quarter.

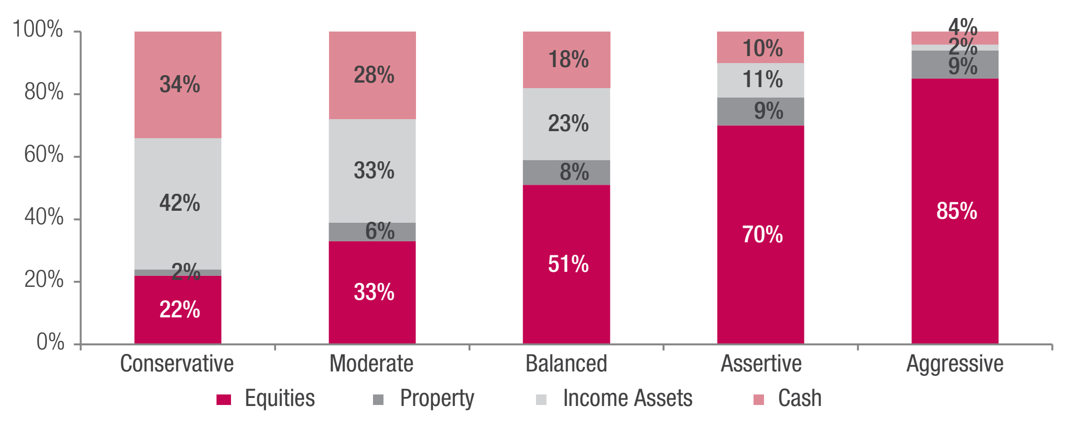
We have modified our Tactical Tilts to reflect our preference for Equities (10% to 11%) over Income assets (-6% to -7%) and Property (0% to -2%). We also lift our cash tilt (from -4% to -2%).

Benchmark long term Asset Allocations and Tactical Tilts

	Conservative	Moderate	Balanced	Assertive	Aggressive	Tactical Tilts
Equities	11%	22%	40%	59%	74%	11%
Property	4%	8%	10%	11%	11%	-2%
Income	49%	40%	30%	18%	9%	-7%
Cash	36%	30%	20%	12%	6%	-2%
	100%	100%	100%	100%	100%	

Source: Morningstar, Morgans

Morgans recommended Asset Allocations inclusive of Tactical Tilts



Source: Morningstar, Morgans

Quick views per Asset class

Equities	Economic conditions in the US are in equity friendly recovery mode, although the pace of recovery and its benefits to Australia have been slower to unfold than expected.
Listed Property	Premium valuations may be more difficult to sustain in a rising US interest rate environment with an eventual change in monetary policy likely to diminish the sector's relative appeal.
Listed Fixed Interest	With security prices having been sold off aggressively we recommend clients take advantage of this weakness and build positions in quality issues.
Government Bonds	Government bond pricing is likely to remain volatile. We prefer term deposits for retail investors given their comparable returns (or better) with government guarantees up to $250k.
Term Deposits	Deposit rates continue to decline as the market prices in the expectation of lower cash rates for longer. The premium on 1-year term deposits above the 1-year swap continues to erode.
Cash	The market expects rates to remain at current levels. The RBA maintains an easing bias, although the marginal benefit of further rate cuts may not have the desired impact given the risks around property prices.

Investment Themes

Notwithstanding current volatility, we continue to structure our investing strategies around core themes:

- Lower for longer interest rates sustaining premiums for reliable dividend payers
- A preference for leverage to superior growth dynamics in the US
- Further downward pressure on the Australian dollar
- Premiums for stocks offering capital management and/or M&A optionality

This quarter we also address two major themes raising investor concerns:

- Weathering market volatility
- Implications of potential US rate rises in 2015

Lower Australian interest rates for longer

Given the risks of rising unemployment in the Australian economy, we expect a further 1-2 cuts in the RBA cash rate through 2015. This should prolong the dynamics supporting the premiums in high yield equities, particularly among utilities, the banks, select financials and industrials capable of sustaining tangible dividend growth. We note that current market events, and their impact on US economic data, may pressure the Fed to maintain its accomodative stance for longer.

However US rates will eventually rise, and we are cognisant that Australia's bond market does correlate well with the US. For this reason we caution that those stocks without tangible dividend growth that are being priced more like bonds than equities face significant risk to capital values. Australian Property REITs in particular look vulnerable at current pricing, hence we have lowered our exposure via our Asset Allocation settings.

Leverage superior growth in the US

The US is currently the locomotive of global growth providing opportunities linked to stronger consumption, housing activity and exports. It's actually difficult to find compelling economic drivers elsewhere. Australia sets to benefit from stronger US growth, however the transition from mining, back to housing and services led growth has been frustratingly slow. China is navigating its own unsettling transition toward consumer led growth, clouding the outlook for the Australian economy, while Europe remains anaemic.

Morgans International Strategy details offshore investing opportunities ranging across direct share ownership, Exchange Traded Funds (ETFs), Listed Investment Companies (LICs) and managed funds. ETFs offer low cost and targeted offshore exposure. The **Vanguard US Total Market ETF (VTS)** offers the simplest proxy to a US market index. We see select opportunities in LICs including the **PM Capital Global Opportunities Fund (PGF)** which is trading at a significant discount to the value of its assets.

Further weakening of the Aussie dollar

Several macro-economic fundamentals support further weakness in the AUD towards Michael Knox's target of 72 cents by year end, namely:

- The US enjoys stronger growth than Australia
- US unemployment is falling
- US earnings are growing
- Australian bond yield premiums are narrowing
- The US is almost certain to raise rates before Australia does

Add to this Australia's deteriorating terms of trade and it's clear that downward pressure on the AUD remains.

A lower AUD provides a boost for Australian exporters (mining, agriculture, manufacturing), service industries and industrials with strong offshore franchises translating profits (and dividends) back into AUD. We expect key offshore industrials to continue to enjoy earnings and price momentum. **Betashares' US Dollar ETF (USD)** offers the simplest direct exposure to the US dollar, which we recommend investors consider as an alternative hedge to holding cash in Australian dollar terms.

Capital management and M&A optionality

Prudent cost management and strong cash flow generation are themes which have commanded the most attention at recent reporting seasons. Companies capable of returning surplus cashflows to shareholders in the form of higher dividends or capital returns have subsequently attracted a market premium. Notable recent examples include **Telstra, Wesfarmers** and **Suncorp,** and we think names like **Energy Developments, Qantas and Vita Group** could surprise via upcoming dividends.

Weak GDP growth and a low cost of capital mean firms are increasingly considering M&A and

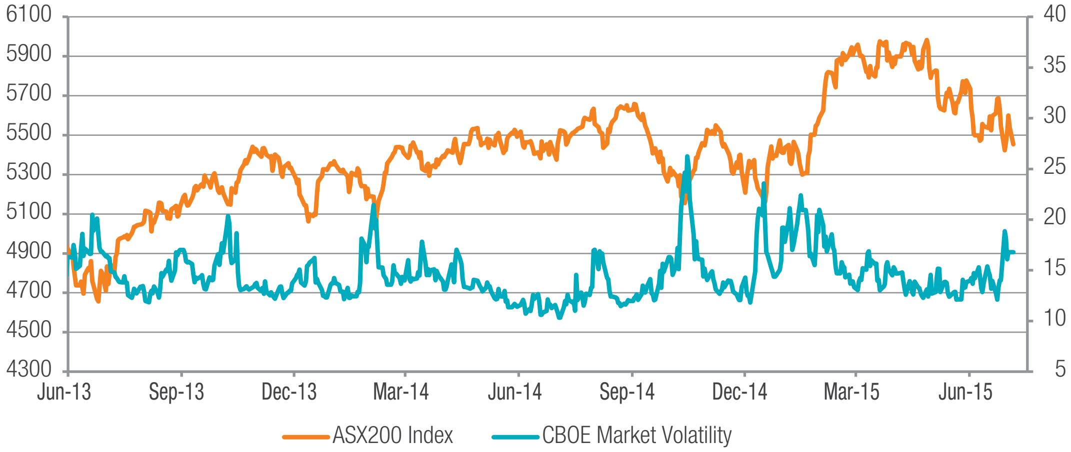
Key equity market themes and key exposures

Macro themes	Key exposures
Australian rates lower for longer	TCL, SYD, Banks, APA
Superior growth offshore	RMD, AMC, MQG
International exposure via ETFs & LICs	VTS, QUS, MGE, PGF
Weakening in the AUD	USD (ETF), MQG, QBE
Capital management or M&A potential	SUN, WES, QAN
Tactical themes	
Brace for higher volatility	Retain cash
Rise of the emerging market middle class	SYD, IPP, CWN
The E-commerce and online boom	SEK, DMP, IPP
Australia's ageing population	CGF, RRL

Source: Morgans

asset divestments to boost returns. In a market with range-bound global interest rates, we advocate tactical positioning into potential M&A targets or stocks unshackling underperforming assets including **Oil Search, M2 Group** and **Challenger Group**. The correction in the Aussie dollar also adds spice to the potential targeting of Australian companies by offshore predators.

ASX Performance versus global volatility



Source: IRESS, Morgans

Weathering market volatility

The Greek default was the last excuse markets needed to correct from their premium level down to below fair value. While disconcerting in the short term, it's important to put what's happening in Greece into perspective.

We know that markets hate unknowns and discount uncertainty. Markets are fearful that a disorderly exit of Greece from the Euro Area will crystallise similar reactions in vulnerable European economies. As discussed earlier, we don't believe the events in Greece will crystallise a second sovereign debt crisis such as occurred in 2012 and ultimately we think the current shock to the stock market will be short lived.

However Greece is only one of several unfolding events which threatens to spike investor uncertainty and market volatility. China is enduring a shock correction, Russia is worrying institutional investors and the bond markets have already baulked at the prospect of rate normalisation.

Higher volatility threatens the re-pricing of market risk leading to lower returns. Crucial for investors in this environment we believe is; to hold higher than usual levels of cash; to not become complacent about capital value; constantly monitor portfolio risk and to moderate expectations of future returns. That said we also think it's instructive to recall the classic investing adage from Baron Rothschild being '*the time to buy is when there's blood in the streets*'.

Implications of US rate rises in 2015

This quarter the US Fed made its most robust statements to date about the inevitable path toward interest rate normalisation. Disruption was immediately felt in both bond and equity markets with Australian banks hit particularly hard.

An environment of abnormally low yields, compressed risk premia and diverging outlooks for monetary policy paints a complex picture for investors over the next 12 months. We do expect the US to begin to lift rates from late 2015. While we do anticipate some disruption as bond markets realign, equally we don't think an initial US rate rise will trigger a panic event.

Consider the following:

- The pace of US rate rises is likely to be very slow. The last thing the Fed wants to do is threaten the US recovery by raising too quickly. Indeed the current disruption may actually require monetary settings to stay accommodative for longer
- When rates do move, they will only move from 'ultra-accommodative' to 'very close to ultra-accommodative' settings. This doesn't warrant a seismic shift in money markets, and
- Markets are prepared for it. This decision has been the most analysed and well telegraphed in the Fed's history. Once the first rate hike is no longer an unknown, we wouldn't be surprised if markets reacted with relief rather than fear.

However we are conscious that low interest rates have distorted the pricing of income yielding equities, enabling more expensive valuations to be justified and without the usual support of earnings growth. Our Income Investing strategy remains focussed on allocating higher weightings toward those companies capable of growing their dividends (and preferably revenue) in a low growth environment (e.g. Sydney Airport, Transurban, APA Group), and lower weightings to those equities simply attracting a premium for their yield arbitrage with risks around their growth (e.g. Property REITs). This is relfected in our Asset Allocation settings and in our Equity Model Portfolios.

Shares

Treading cautiously through 2015

Australian shares suffered an ignominious end to the 2015 financial year, handing back over 7% of gains to finish the year only 1.2% ahead, before dividends of about 4.5%. As we had feared, the sharp correction in bond markets and more recently the turmoil in Greece were all that were required to unwind some abnormal market positioning seen in the first quarter and to relegate the market from its lofty premium.

Our market is trying to reconcile the positive forces being created by a lower interest rate environment for longer, against several forces which are compounding investor caution including sluggish global growth, flat corporate earnings, and markets which are still trading at historical premiums thanks only to abnormally low interest rates.

This is not an environment for investors to be heroic and we maintain a cautious investing stance heading into the new financial year. This includes holding higher-than-average levels of cash (to capitalise on market volatility) and to allocate more capital toward international opportunities.

Despite a gloomy top-down view, recent weakness has uncovered some interesting tactical opportunities, particularly among the +15% correction in the banks (see below). We also remind investors of the strong performance of the Morgans Model Portfolios and High Conviction Lists which prove that strong returns are achievable in this environment through highly selective stock picking.

Industrials – a mixed outlook

The outlook for industrial companies looks patchy. Domestically focused companies impacted by the cyclical downturn in resources remain in transition and are yet to see much benefit from Government infrastructure spending. Meanwhile, the clear outperformers look to be those stocks generating strong offshore earnings thanks to exposure to the US economic recovery and a falling Australian dollar.

We currently favour companies with defensive qualities given current volatility in global markets. **Amcor** and **Orora** in the Paper and Packaging sector tick all the boxes (no pun intended) with both companies having a strong presence in the US. The defensive nature of their end markets (mostly food and beverage) provide relatively stable earnings growth that is largely shielded from global economic fluctuations. Market nervousness should see these stocks be well supported in coming months with **Amcor** our preferred pick.

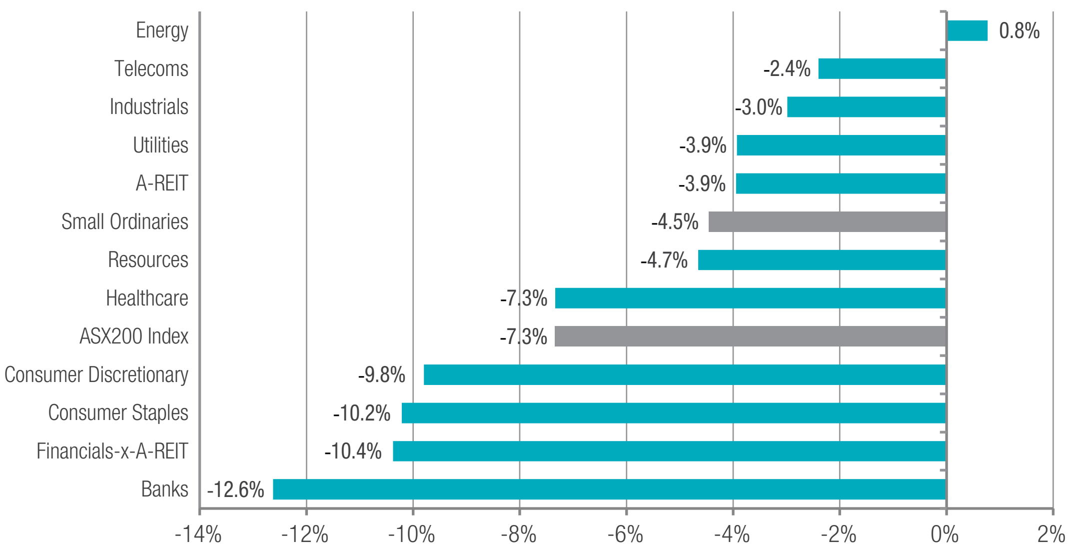
We anticipate positive momentum for companies exposed to residential building activity (both new build and renovations) for at least the next 18 months. Building materials and housing leveraged stocks will not only benefit from an increase in volumes (higher housing starts) but from margin gains given the benefits of scale. We caution that the valuations for such stocks look pricey, so investors need to tread carefully here.

Merger and acquisition activity has jumped as corporates seek alternative growth avenues due to the tepid global economy. Toll Holdings was recently acquired by Japan Post; Iron Mountain has bid for Recall and Brookfield has made an indicative proposal for Asciano. M&A activity is highly unpredictable and we remain focussed on established industrial companies with strong competitive advantages.

Healthcare – thinking globally

The first half of 2015 has seen healthcare stocks move broadly in line with the ASX200. Our recent global healthcare report expands our Healthcare coverage beyond Australian listed companies. This in part has been driven by the limited investment opportunities in Australia where Healthcare

June quarter 2015 relative sector performance



Source: IRESS, Morgans

represents only 5% of the ASX200 compared with Healthcare representing 15% of the global MSCI index.

The key themes are broadly similar, namely:

- an ageing population
- medical innovation, and
- increasing costs lifting government reliance on the private sector.

We are now focussed on a greater range of opportunities including Merck (MCK.NYS, not rated) in pharmaceuticals, Express Scripts (ESRX.NYS, not rated) in healthcare services and Medtronic (MDT.NYS, not rated) in medical devices. These international names sit beside our key ASX listed recommendations of **CSL** (pharmaceutical), **Ramsay Health Care** (hospital) and **ResMed** (medical device).

Telco – lock in some gains

Telecommunications stocks performed well in FY15 assisted by mergers and acquisitions which have delivered scale benefits to the acquirers and trading premiums for the targets and their peers. After several years of consolidation and solid organic growth, we now think it's becoming far harder for these companies to grow.

Sector valuations are looking reasonably stretched hence we have reduce recommendations on a number of stocks including iiNet (IIN) and TPG Telecom (TPM). IIN is a solid business but there are some concerns around the TPM offer and the possible impact of an ACCC ruling on their takeover bid for IIN. Investors can take the TPM offer price now (sell on market now rather than wait months) and eliminate any ACCC related risk. Ultimately we don't expect a higher offer to emerge for IIN.

We think **Telstra** remains a crucial part of any portfolio. The dividend is comfortably covered by cash flow and the balance sheet is significantly under-geared which delivers M&A optionality should the right opportunities emerge. Our preferred telco pick remains **NextDC** with the company recently winning a major contract with a leading global corporation which we think endorses the business model and fast tracks sales.

Banks – buying the pull-back

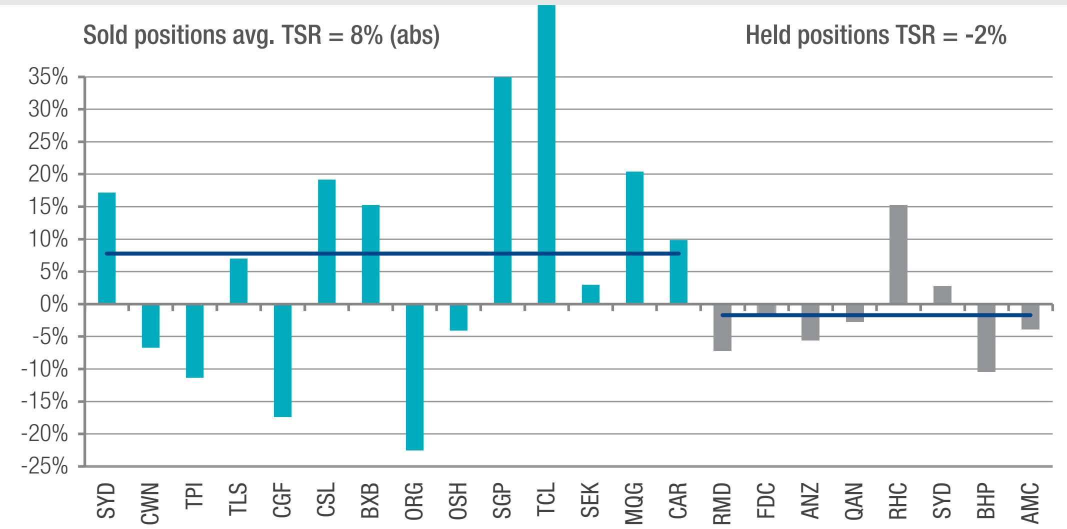
Following their sharp correction, the major banks have now settled at prices roughly in line with their long term average earnings multiples and dividend yields. The lower for longer interest rate environment, coupled with the real possibility of further falls in domestic rates, suggests that the banks have provided investors with a buying opportunity at current levels.

The key driver of the banks sell-off appeared to be the global bond sell-off. This is significant as it actually signifies that markets were becoming more confident on growth leading to a normalisation in interest rates. High yield stocks subsequently suffered. While improving offshore fundamentals could see the marginal offshore investing dollar directed elsewhere, the normalisation of global rates is likely to be a very slow story to unfold.

Key investors in the major banks look highly supportive. Domestic institutions have been lifting their positions in the sector for the first time in a number of years, thanks to the attractive yields and earnings certainty against a very mixed economic backdrop and broader market. Retail investors stand to gain a good yield pick-up relative to term deposits (~2.5%) and rental yields (~3.5%).

We are happy to buy banks at current levels. Our current order of preference is **ANZ Bank**, **Commonwealth Bank** and **National Australia Bank** (all portfolio stocks) followed by Westpac which we view as relatively expensive.

Morgans High Conviction stock performance: sold and current positions



Source: Morgans

Disclaimer: Morgans Financial Limited (Morgans) does not formally research the International Healthcare companies mentioned above.

Shares

Diversified financials – opportunity amid short term pain

Heightened volatility due to the Greek debt crisis is generating short-term weakness in diversified financials stocks which are heavily leveraged to equity markets and currency movements. Whilst some short-term caution is warranted, when the resolution ultimately unfolds we believe our preferred financials exposures are well placed longer-term.

We continue to back stocks leveraged to three key themes:

- Sustained momentum in offshore earnings and funds flows
- Further AUD depreciation, and
- The ongoing shift of Superannuation funds to retirement phase in Australia.

Our preferred stock exposures in the sector are **Macquarie Group, BT Investment Management**, and **Challenger Group**.

We're still neutral on the General Insurers given the increasingly competitive environment in domestic general and commercial insurance. This is despite Warren Buffet entering the Aussie market via an investment in Insurance Australia Group. **Suncorp Group** remains a solid portfolio holding, however we retain a neutral view given growth headwinds.**QBE Insurance** still presents a slightly higher risk/reward proposition, but is our preferred sector exposure at present. We think QBE is on track for a solid 1H15 result given favourable global weather and potential upside from its turnaround strategy and leverage to rising bond yields.

Resources – navigating the lows

Resources stocks fell 5% in the second quarter, but did outperform the broader market helped by relief rallies in oil and iron ore off their lows.

We continue to believe investors should maintain no greater than a market weight exposure to resources. We are confident that the sector downturn has entered a mature phase, but continue to wait for signs of recovery in commodities demand (particularly out of China) before increasing our conviction. We continue to think the sector is navigating the bottom of the cycle.

Our preferred sector exposures remain established mining and energy franchises with robust profitability and significant financial stability, such as **BHP Billiton** (who has repeatedly cut expenditure to substantially grow free cash flow), **Oil Search** (with production from the high-margin PNG LNG project now fully ramped up), and **Santos** (with first commercial LNG production now imminent from the GLNG project and resulting growth and further diversification of earnings).

On the upside, China's central bank has clearly flagged its willingness to utilise monetary and fiscal policy measures in order to combat weakening growth and falling inflation. There is a very real scenario where central bank action becomes more aggressive in the second half which could lead to an unexpected rally across key commodities.

Consumer staples and discretionary – stick with the niche players

The state of the consumer is always very topical and is often used as a barometer for the state of the broader economy. Consumer sentiment continues to be volatile and remains slightly below the long term average. As such, the consumer remains fragile and value focused which we have witnessed in recent earnings confessions from Flight Centre, Woolworths and Oroton. The buoyant housing market has been a clear positive for some retailers, as is the small business incentives recently announced in the Budget.

The sharp fall in the AUD is also a headwind for retailers. Most are hedged through 2015 after which they will have to lift prices (or lower product quality) or suffer margin pressure. Lifting prices amid fragile consumer confidence will be difficult, hence we believe that margins will be squeezed across the sector.

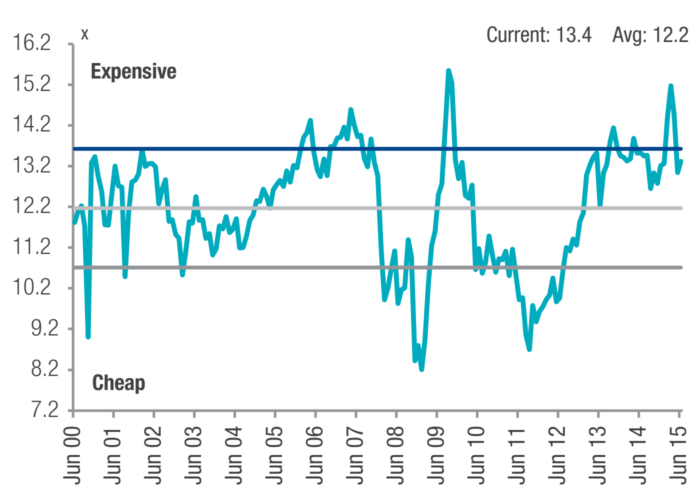
Lower fuel prices (although these have increased more recently), further interest rate cuts, and a buoyant housing market offer potential stimulus to consumer spending, although these are balanced against poor wage inflation and a questionable unemployment outlook. On this front, we continue to maintain a market weight exposure to consumer staples and a clear preference for **Wesfarmers**. We also favour those retailers exposed to the strong housing segment such as **Harvey Norman** and **Beacon Lighting**. We also maintain a preference for speciality retailers with strong structural growth and offshore exposure being **Domino's Pizza, Lovisa** and the recently listed **Adairs**.

Online media – oversold

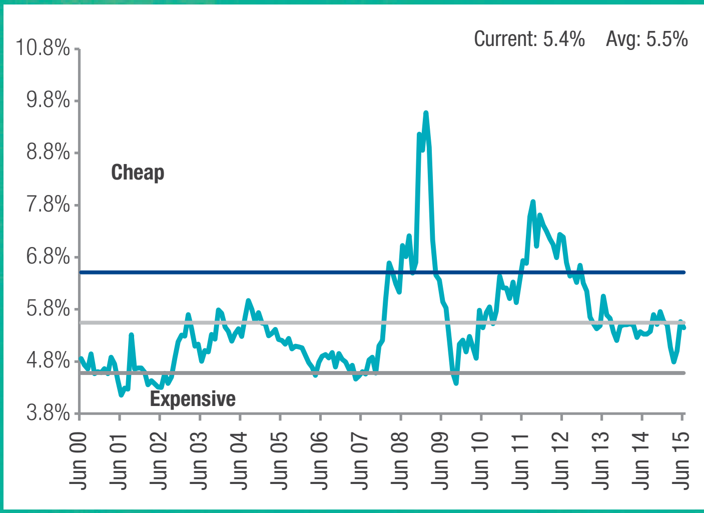
Australia's online media sector had a horror quarter with the Morgans online sector index dropping 19% and underperforming the market by 12%. Weak March quarter sales reported by REA, a profit downgrade by SEEK in June and flight of investors away from high PE multiple stocks all contributed to the selling pressure. We believe that the selling is overdone and in a market where organic earnings growth overall will be lucky to reach 3% over the next two years, we think the marginal investors will return to the sector over the next half.

Our preferred exposures for long term investors remain **SEEK** (employment and education) and **iProperty Group** (Asian real estate). We believe both companies are able to deliver double-digit earnings growth for many years to come. While high-growth stocks such as these are volatile, they are a sensible inclusion in any growth-oriented portfolio.

Banks - Consensus sector PE multiples (LH Chart) and yields (RH chart) have now corrected back toward long term averages



Source: Factset, Morgans



Source: Factset, Morgans

Infrastructure – accumulate on weakness

Share prices of key infrastructure stocks retreated this quarter. Investors were spooked by rising Australian Government bond rates, with 10 year bond rates having risen over 70 basis points from historical lows back to the level seen late last year. We view this as a return from over-exuberance to more rational valuations. Longer term, we expect global, industry, and company specific drivers to have a greater impact on the performance of infrastructure stocks than movement in bond rates.

Recent key events included APA Group completing its acquisition of the QCLNG gas pipeline, Sydney Airport successfully concluding negotiations with international airlines, and Transurban hosting an investor day. M&A activity continues with Asciano receiving an indicative takeover bid and the NSW Government commencing the sale process for its electricity businesses where we expect AusNet Services and Spark Infrastructure to be involved in bidding.

The August reporting season will be important as it will see FY16 guidance provided by companies reporting on a June year end basis. We currently see **APA Group** and **Sydney Airport** as the most attractive opportunities at current prices.

Agriculture/Food – an eye on El Niño

The listing of the Murray Goulburn Unit Trust provides investors with an economic exposure to Australia's largest dairy foods company. Given dairy prices are at a cyclical low, over coming years, Murray Goulburn's earnings offer upside from improving dairy fundamentals, a falling AUD and investments in higher margin, value added products. The company also offers investors an attractive fully franked distribution yield.

While recent rainfall has been positive for the sector, the Bureau of Meteorology still forecasts an El Niño event later this year. If proven correct, this could see share prices weaken across the sector. The company which would be most affected by El Niño under our coverage is GrainCorp, while Ridley Corporation would be least affected. Heading into August we're expect strong results from key picks **Bellamy's Australia** and **Capilano Honey**.

Property

In extending its stellar run, the property sector continues to perform solidly delivering a total return of around 20% over the past financial year versus the broader market return of around 6% including dividends. Key drivers of this performance have been the low interest rate environment (driving yield arbitrage) as well as merger and acquisition activity with many groups struggling to grow organically.

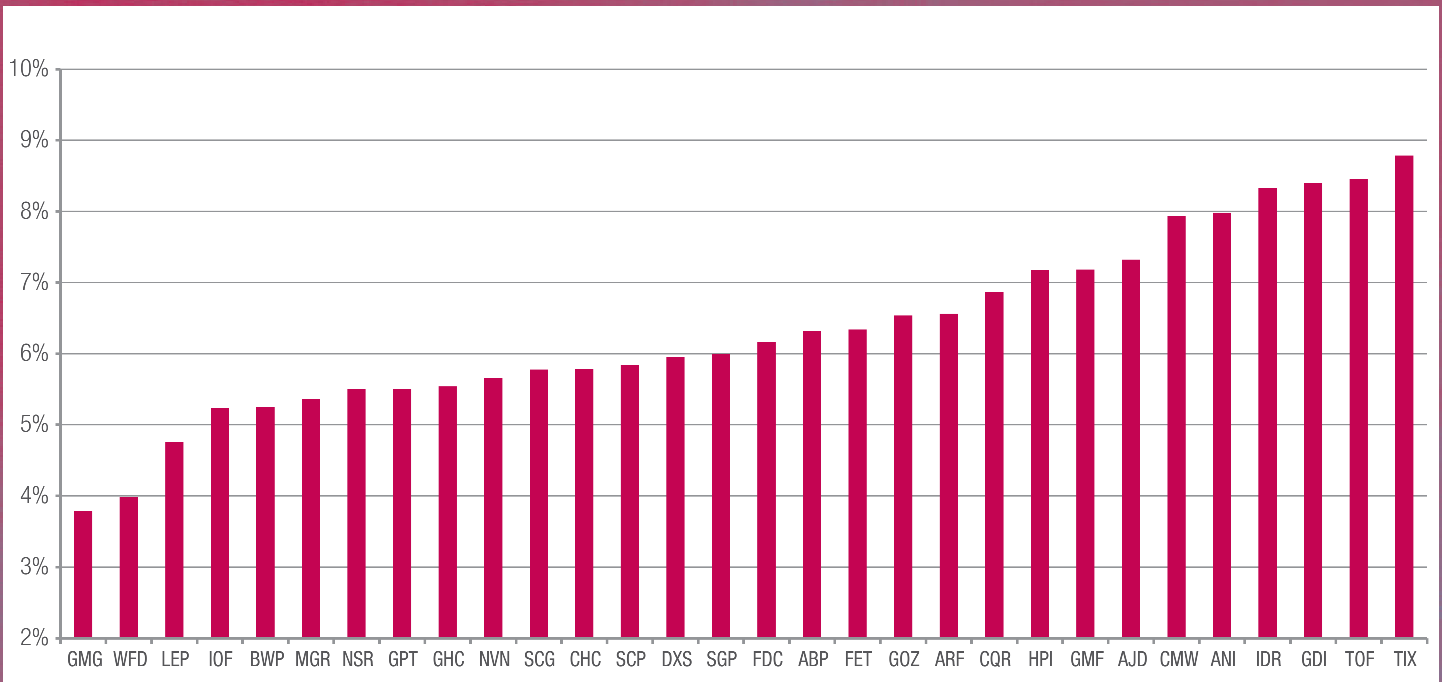
While property companies are broadly in good health, we are worried that the eventual upward movement in US interest rates will place capital values (share prices) at risk as we think the sector has exhibited 'bond-like' qualities on its way to significantly outperforming all others in the last two years. As **global rates normalise, we think that Property REITS are among the most vulnerable of asset classes to the reversal of the yield arbitrage trade and we have adjusted our Asset Allocation settings this quarter accordingly.**

Our preferred REIT exposures include **360 Capital Industrial Fund** (industrial exposure) where the lease expiry profile is strong at 5.8 years and the FY16 distribution yield is over 8% and paid quarterly. **Cromwell Property Group** (office exposure) has a five year weighted average lease expiry and a track record of managing cycles which we believe will help buffer against near term challenging office markets. The yield remains attractive and is paid quarterly. Cromwell also now has exposure to offshore funds management via its acquisition of Valad Europe.

We also continue to prefer REITs with exposure to niche sectors/high barriers to entry such as **National Storage REIT** (self-storage), **APDC Group** (data centres) and **Generation Healthcare REIT** (healthcare).

Our preferred retail exposure remains **Federation Centres** which is in our High Conviction list and following the merger with Novion Property Group is now a top 30 stock and the third largest REIT delivering a yield of around 6%. For diversified exposure we continue to prefer **Stockland Group** which has good leverage to the residential markets. For global exposure we continue to highlight **Westfield Corporation** although we note it's not for pure yield investors.

AREITs: FY15 forecast distribution yields



Source: Factset, Morgans

Income

Cash

The RBA kept the Official Cash Rate at 2.00% during June. We remain of the view that the next move in interest rates will likely be down, and expect rates to remain low for an extended period of time. The best rate on an at call account is the Westpac/DDH Graham CMA where investors will receive 2.40%.

Term Deposits

The average of one year term deposit rates as reported by the RBA fell 5bp to 2.45% in June. This rate has continued to slide and has fallen from 3.05% at the start of the year and we expect it to tick lower over the remainder of the year. The highest term deposit rates on offer for 180 days and 365 days are 2.95% and 3.05% respectively.

Government Bonds

There continues to be high levels of volatility in the Australian Government bond market as global factors and domestic data releases cause investors to reassess both global and domestic growth expectations. We have recommended clients remain underweight government bonds and utilise term deposits as an alternative given the price volatility of the former. This price volatility can impact client principal if funds need to be realised before the security matures. During the month, three year government bond yields rose 14bp to 2.02% while 10 year yields jumped 28bp to 3.01%.

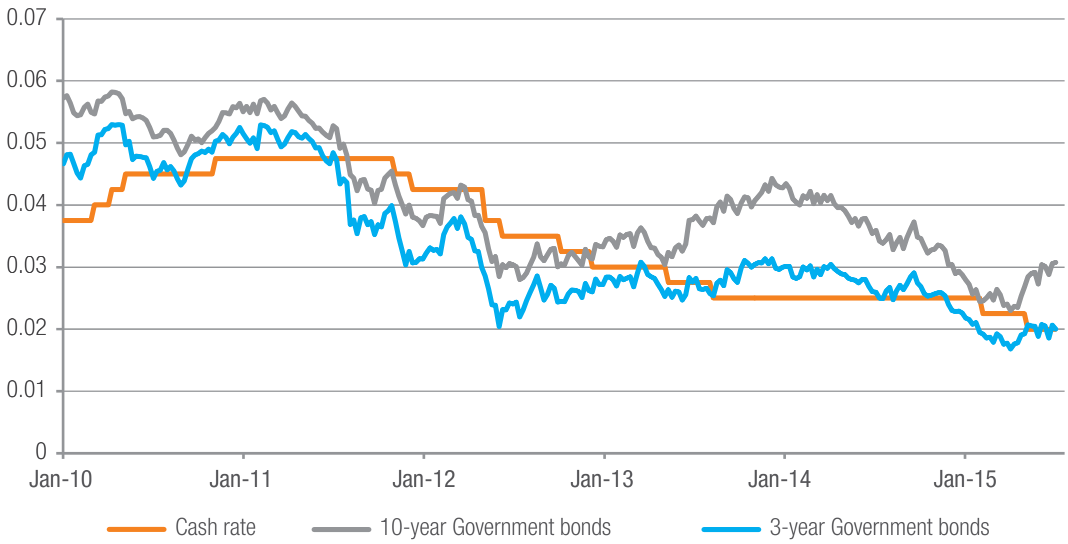
Listed Fixed Interest

Price volatility persisted as we moved toward the end of the financial year and investors took advantage of higher equity yields following the ASX200 sell-off. This has created an opportunity for investors seeking to enhance their income by utilising hybrid securities. Our preference remains toward shorter-dated securities and in the financial space we prefer **ANZPA** (Add, 5.12% yield to call), **CBAPC** (Add, 6.24%) and **WCTPA** (Add, 5.40%) while our key corporate picks are **AQHHA** (Add, 5.25%) **GMPPA** (Add, 6.01%) and **ORGHA** (6.48%).

We also believe that the BHP Exchange Traded Corporate Bond ETF offers good value for conservative investors. While the security has a low yield to maturity of around 2.4%, we are comfortable with the credit given the strength of BHP's balance sheet and highlight this security as an alternative investment for clients seeking to deploy funds outside term deposits.

Further cuts to Australian interest rates are likely to sustain the current demand for high yield instruments.

Australian Government bond yields versus the RBA cash rate



Source: IRESS, Morgans

Model Portfolios

Morgans actively manages a series of Model Portfolios for use as guides for various investing styles across the Equity, Listed Property and Fixed Interest asset classes. Investors may use these Portfolios individually or within the Morgans Asset Allocation framework.

The Monthly Model Portfolio Performance reports detail the aims of each portfolio, track performance, portfolio metrics and rationale for monthly changes. Subscribe via the Morgans website or contact your adviser for more detail.

Income Portfolio

The Income Portfolio continues to significantly outperform the market over the medium-to-long term. Given the steady deterioration in the outlook for Australian interest rates, we think that high yield investments will continue to command market premiums through 2015. That said, we are mindful that the current ultra-low interest rate environment is unsustainable in the long term, and that investors should not become complacent about risks to capital value when that adjustment inevitably does occur.

Adjustments to the portfolio this quarter centred around improving the defensive nature of the holdings in order to protect capital values, without sacrificing overall yield. We accumulated further exposure to the banks on their recent weakness, namely via entry into Commonwealth Bank and the National Australia Bank entitlement offer. We also added Energy Developments to the portfolio in belief the company offers significant upside to our current dividend expectations.

Balanced Portfolio

The Balanced portfolio has tracked the market over a long period now, with outperformance of the 'Income' component of the portfolio (Telstra, Transurban), and the offshore facing exposures (Amcor, Macquarie, CSL) weighed down by its Resources exposure (BHP Billiton, Oil Search) and higher beta names in financials (Challenger, BT Investment Management).

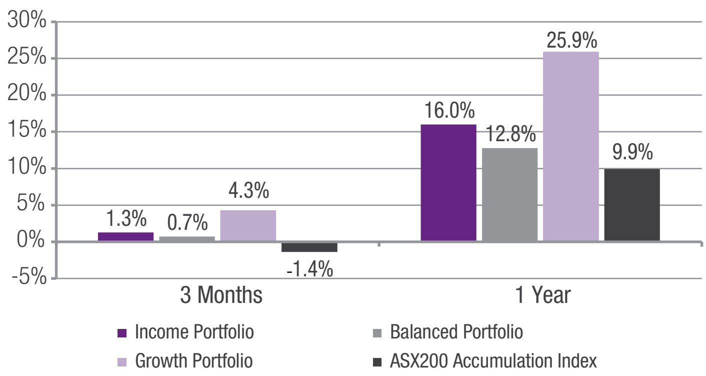
We do expect the eventual rotation from overweight market positioning in Income stocks into Growth, in line with a steady economic recovery to the benefit of Balanced and Growth portfolios. However we believe the timing of this trajectory continues to push out, particularly with renewed uncertainty in Chinese and European markets this quarter.

Growth Portfolio

The portfolio continued its stellar run into the end of FY15, significantly outperforming the volatile market. Current and former High conviction stocks like Macquarie Group, Domino's Pizza, IPH, Corporate Travel and Beacon all performed strongly through the quarter and more impressively have largely held their ground through recent volatility.

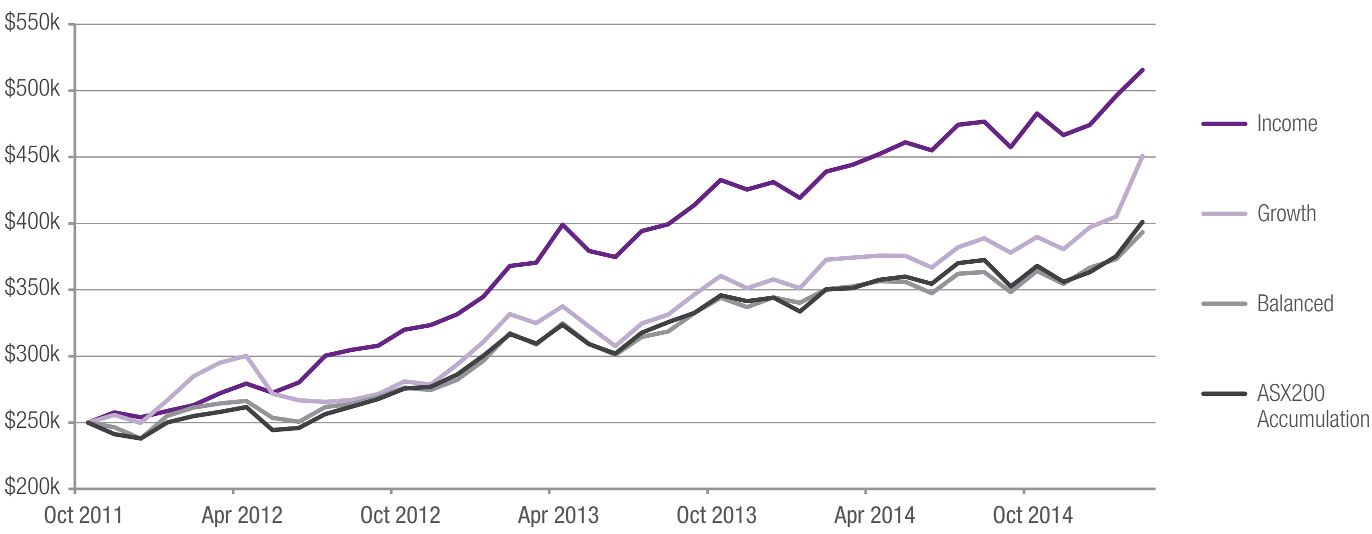
The portfolio has significantly outperformed the market over the medium term despite benign growth in Australia. We continue to seek leverage to relatively stronger growth potential offshore, with half the Portfolio's revenues derived either in US dollars or from outside Australia.

Equity model portfolio performance to 30 May



Source: Morgans, IRESS

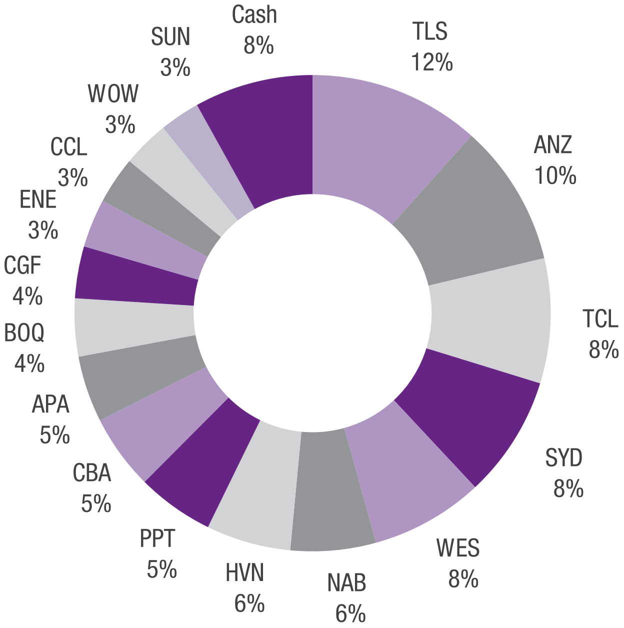
Cumulative Equity Model Portfolio Performance Since Inception (November 2011)



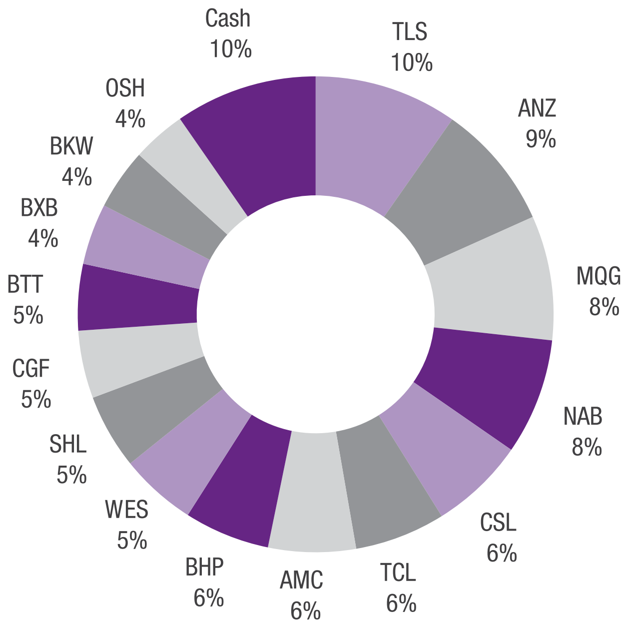
Source: Morgans, IRESS

Morgans Equity Model Portfolio constituents

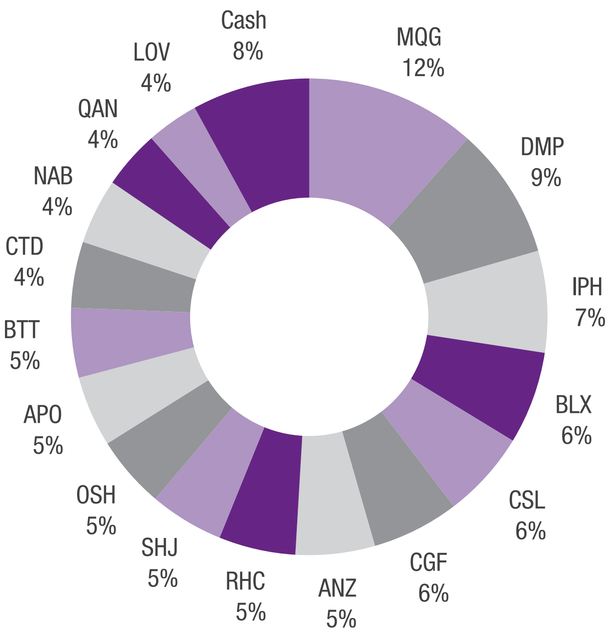
Income



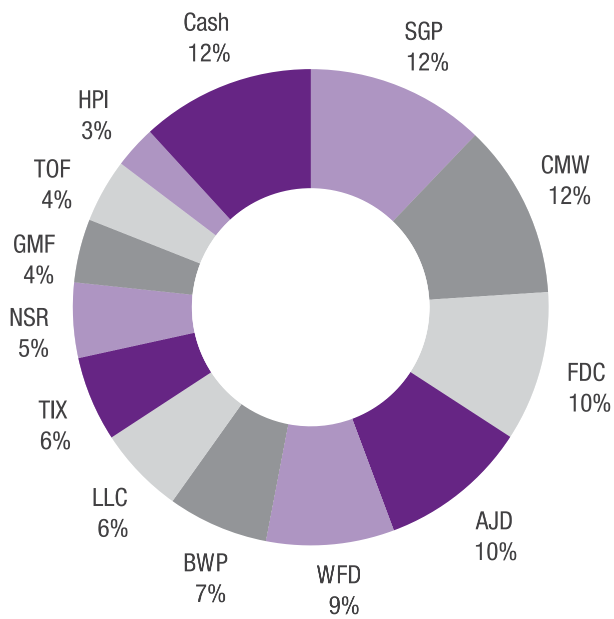
Balanced



Growth



Property



Source: Morgans

Queensland

Brisbane Stockbroking, Corporate Advice, Wealth Management	+61 7 3334 4888
Brisbane Edward St	+61 7 3121 5677
Brisbane Tynan Partners	+61 7 3152 0600
Bundaberg	+61 7 4153 1050
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Caloundra	+61 7 5491 5422
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Townsville	+61 7 4725 5787
Yeppoon	+61 7 4939 3021

New South Wales

Sydney Stockbroking, Corporate Advice, Wealth Management	+61 2 7903 2777
Armidale	+61 2 6770 3300
Ballina	+61 2 6686 4144
Balmain	+61 2 8755 3333
Bowral	+61 2 4851 5515
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Sydney – Level 9	+61 2 8215 5000
Sydney – Level 7 Currency House	+61 2 8216 5111
Sydney Hunter St	+61 2 9125 1788 +61 2 9615 4500
Sydney Reynolds Equities	+61 2 9373 4452
Wollongong	+61 2 4227 3022

Victoria

Melbourne Stockbroking, Corporate Advice, Wealth Management	+61 3 9947 4111
Brighton	+61 3 9519 3555
Camberwell	+61 3 9813 2945
Carlton	+61 3 9066 3200
Farrer House	+61 3 8644 5488
Geelong	+61 3 5222 5128
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South Yarra	+61 3 8762 1400
Southbank	+61 3 9037 9444
Traralgon	+61 3 5176 6055
Warrnambool	+61 3 5559 1500

Australian Capital Territory

Canberra	+61 2 6232 4999

Northern Territory

Darwin	+61 8 8981 9555

Tasmania

Hobart	+61 3 6236 9000

Western Australia

West Perth Stockbroking, Corporate Advice, Wealth Management	+61 8 6160 8700
Perth	+61 8 6462 1999

South Australia

Adelaide	+61 8 8464 5000
Norwood	+61 8 8461 2800

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Adairs: Morgans Corporate Limited was a Co-Lead Manager to the prospectus offer by Adairs in May 2015 and received fees in this regard. PGF: Morgans Corporate Limited was a Joint Lead Manager to the public offer by PM Capital Fund in November 2013 and received fees in this regard. IPP: Analyst owns shares. TCL: Morgans Corporate Limited was a Co-Manager to the Transurban Group rights issue in May 2014 and received fees in this regard. BLX: Morgans Corporate Limited was the Lead Manger to the public offer of shares by Beacon Lighting Group Ltd in April 2014 and received fees in this regard. LOV: Morgans Corporate Limited was a Joint Lead Manager to the initial public offer of Lovisa and received fees in this regard. TIX: Morgans Corporate Limited was a Joint Lead Manager and Underwriter to the placement and rights issue for 360 Industrial Fund and received fees in this regard. GHC: Morgans Corporate Limited was a Joint Lead Manager to the placement and rights issue for Generation Healthcare REIT and received fees in this regard.

Recommendation structure

For a full explanation of the recommendation structure, refer to our website at https://www.morgans.com.au/research_disclaimer.

Research team

For analyst qualifications and experience, refer to our website at https://www.morgans.com.au/research-and-markets/our-research-team.

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