

Month in Perspective

August 2017

WESTERN AUSTRALIA

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Overview

The whispering campaigns of global central banks reflect widespread uncertainty and a degree of apprehension. All central banks have new captains at the wheel since the GFC.

While all believe tightening monetary policy is desirable, after eight long years of stimulus, committees are yet to establish a decisive strategy or at least communicate one.

Procrastination reigns supreme and volatility has returned to currency markets. Investment banks' trading desks cheer.

Paul Volcker, the chair of the Federal Reserve under Presidents Jimmy Carter and Ronald Reagan, said "tightening is the hard part," and today's central bankers are finding out just what he meant.

Janet Yellen has not been convincing. After raising the federal funds rate in March and June, the possibility of a third increase is on the backburner. December is the uneasy market favourite.

In her semi-annual testimony before Congress, Yellen admitted the current federal funds rate was not far away from a neutral or Goldilocks setting--neither expansionary nor contractionary. This is at odds with the June Dot Plot.

A day after Yellen's testimony, a subdued June core consumer price index and tepid retail sales put paid to any suggestions of a more aggressive stance. The plan to reduce the Fed's bulging balance sheet was previously outlined.

While 1 October would be a convenient start date, Congress will have to raise the debt ceiling before

the Fed can begin the program, as it requires meaningful outlays.

Due to heightened uncertainty on several fronts, the US\$ has slumped, helped by an unpredictable President and White House comings and goings.

The Federal Open Market Committee left the fed funds rate range unchanged at 1.00 per cent-1.25 per cent at its 26 July meeting. "Inflation on a 12-month basis is expected to remain somewhat below 2 per cent in the near term but to stabilise around the committee's 2 per cent objective over the medium term".

No starting date for balance sheet contraction was provided other than "the committee expects to begin implementing its balance sheet normalising program relatively soon". More procrastination.

Futures pricing data indicate markets assign a roughly 20 per cent probability the fed funds rate will exceed 1.5 per cent by June 2018. The US\$ took another tumble. Good for international companies, not so good for overseas travel.

On the other side of the Atlantic, European Central Bank (ECB) president Mario Draghi beat his chest and then pleaded he was misinterpreted. The implications were the 60 billion euro per month asset purchases were going to be trimmed before they were due to end in December.

As the euro soared, he back-peddled, claiming misinterpretation, but ECB minutes confirmed the ultra-loose monetary policy is nearing an end. Then a backflip. Rates were left unchanged at the 20 July meeting and asset purchases will continue until December "or beyond, if necessary".

Over the month, the euro has strengthened from 1.1134 to 1.176 against the US\$. As German exports become more expensive, the DAX has peeled almost 5 per cent.

Back home, the minutes of the July meeting of the Reserve Bank board revealed members discussed

neutral interest rate settings. The market quickly and wrongly jumped to conclusions the official cash rate was about to be raised from 1.5 per cent to 3.5 per cent.

The A\$ pushed towards 0.80 against a weakening US\$. Deputy governor Guy Debelle was given the task to hose down the misinterpretation in a rather comical "ready, set, wait" as Governor Philip Lowe put away the starter's gun.

Debelle had to admit a plethora of global and domestic issues mean normalisation of Australian interest rates is in the distance.

Why can't markets understand what central bankers are saying? Or is it because the central bankers are confused and therefore their communications are without clarity and open to misinterpretation?

Could the Reserve Bank be silently cheering the hike in energy costs?

The consumer price index (CPI) is the broad measurement of inflation. Headline CPI counts all components of the index. The core CPI excludes the volatile components of food and energy.

The Australian economy will face significant increases in energy costs from 1 July, over and above higher costs of the past year. All goods and services purchased by Australian consumers, whether they are imported or domestically sourced, will have some energy component in their cost.

Companies will either fully or partially absorb the increased costs or pass them on. If the latter, it will have core inflation implications as headline prices rise and the energy component would be difficult to extract to calculate a real core number.

The Australian Bureau of Statistics will not bother, so increases in the core will be driven by an energy component. More of the headline increase will seep into the core. Meanwhile, household disposable income is trapped between vice-like jaws.

The June quarter headline CPI increase of 0.2 per cent was half the 0.4 per cent expected. Year-on-year (y/y) inflation was 1.9 per cent against expectations of 2.2 per cent. Wages growth was weak and lower fuel and fruit prices helped dampen the number.

But these components (energy and food) are excluded from the core, pushing it to an increase

of 0.5 per cent, in line with expectations, for a y/y increase of 1.8 per cent. The hawks on the RBA board were disappointed and there will be no change in interest rate policy.

The A\$ weakened below 0.79 against the US\$, but after more dovish commentary after the July FOMC meeting and the attempt to repeal Obamacare failed in the Senate with seven Republicans voting no, the US\$ continued to slide. The A\$ now sits near 0.805, not helping the Australian economic equation, and could trigger some offshore selling in the equity market. RBA governor Lowe is not smiling.

The absence of inflation, despite the massive post-GFC stimulus programs, has central bankers and financial markets stumped. The reliance on or belief in the Phillips Curve, which professed the tendency for inflation to rise as labour markets tightened, has been shattered as the curve flat lines.

The US unemployment rate has fallen from 10 per cent to below 5 per cent, yet inflation has not come to the Phillips Curve party.

In fact, the Fed's preferred measure of inflation, the core personal consumption expenditure (PCE) index, has declined from 2 per cent in early 2012, when the unemployment rate was 8.3 per cent, to 1.4 per cent in May.

Despite a general tightening in global labour markets, global inflation is benign. The bottle is open but the inflation genie is stubbornly bottle-bound. Technology has advanced, globalisation has embraced emerging economies, and labour-saving disrupters are in the ascendency, all driving costs and inflation lower.

Value-added processes are less labour-intensive. Labour is being added in the lower-paid services sector, mainly hospitality, healthcare, childcare and aged care, creating a headwind for wages growth.

As union membership declines and enterprise bargaining agreements become more commonplace, the danger of wage push inflation subsides.

A belated revival of the Phillips Curve scenario is possible but unlikely in the near term. Any revival is likely to be muted.

So, when Janet Yellen confessed US interest rates are not far from neutral, it may be interest rates

and bond yields will not return to historical levels, if inflation remains stubbornly below central bank targets in the medium to longer term.

The sell-off in bond proxies could be over and the "bondcano" a fizzer. The consumer price index (CPI) is the broad measurement of inflation. Headline CPI counts all components of the index. The core CPI excludes the volatile components of food and energy.

Chinese visitor boom moving into second gear

Chinese tourists see Australia as a safe and in the (time) zone destination. In addition, a heightened focus on shopping has abated and an increasing preference for natural environments sees Australia moving sharply up the desirable destination list.

In 2017, Chinese tourists will outnumber New Zealanders, taking the premier position for the first time. Over 1.35 million Chinese tourists are expected to visit Australia in 2017. In the past decade, the number of Kiwis visiting our shores increased by 26 per cent. Chinese numbers have exploded by 285 per cent.

Big-spending Chinese overtook the frugal Kiwis as the most valuable visitors many years ago. As improved connectivity and geography put Kiwis at the top of the inbound tourist list, so the former is driving the Chinese to the premier position, which is likely to be maintained for decades.

Direct flights from an increasing number of Chinese regional cities could drive annual tourist numbers through 2 million by 2022.

The most recent survey conducted by Asian investment group CLSA revealed Australia as the fourth most desirable tourist destination behind Japan, Thailand, and the US over the next three years. Safety concerns affected the enthusiasm for European destinations.

The survey revealed the inferred number of potential Chinese tourists is 2.9 million annually in three years. While highly unlikely to occur, it provides a clear message to Australian airport and tourism operators of the potential on our doorstep.

It is almost certain Australia will welcome over 2 million Chinese tourists annually within five years--a positive for Sydney Airport (ASX: SYD).

Peter Warnes

Industrial Stocks

Primary Health Care \$3.39

Primary Narrows Guidance in Line with Expectations and Flags Write Down of Medical Centre Assets

Recommendation: Accumulate	FY2018 Yield: 3.56%
Intrinsic Value: \$ 4.0	Franking: 100%
Risk: Medium	FY2018 PER: 16.85x
12 mth history: \$3.18 - \$4.31	Market Cap: \$1768m

We maintain our AUD 4.00 per share fair value estimate for no-moat Primary Health Care after management guided to a fiscal 2017 underlying NPAT of about AUD 92 million, which is at the lower end of its previous guidance range but in line with our forecasts. Primary also expects to book a noncash impairment charge of about AUD 575 million relating mostly to Medical Centres goodwill and underperforming sites. This compares with interim goodwill of about AUD 850 million for the division. As such, we see this as a clearing of the decks ahead of the arrival of incoming CEO Dr Malcolm Parmenter in September. At current levels, shares in Primary are trading at an 11% discount to our intrinsic assessment.

We think a write down of medical centre assets was inevitable given the lacklustre performance in the division stemming from challenges in recruitment of general practitioners, or GPs, compounded by an overly high exposure to bulk billing under Medicare in the business. Nonetheless, we see this situation improving with the reinstatement of indexation of Medicare rebates for general practitioners, or GPs, announced in May's federal budget.

Notwithstanding efforts to expand its private billing business, which would add upside to our assumptions, we forecast revenue growth for the medical centre division of about 2.5% from fiscal 2019 onwards. Nevertheless, our no-moat rating remains intact and reflects lack of sustainable competitive advantage largely due to the reliance on GPs to drive operating efficiencies given the company's large-scale format sites both directly and indirectly through their gatekeeper role with referrals to medical specialists, diagnostics and allied health services.

Analyst: Chris Kallos

Ramsay Health Care \$70.58

Ramsay Ramps Up Pharmacy Push, Shares Remain Undervalued

Recommendation: Accumulate	FY2018 Yield: 2.05%
Intrinsic Value: \$ 87.0	Franking: 100%
Risk: Medium	FY2018 PER: 24.84x
12 mth history: \$62.15 - \$84.08	Market Cap: \$14263m

We maintain our AUD 87 per share fair value estimate for narrow-moat Ramsay Health Care ahead of the release of fiscal 2017 results on Aug. 30, 2017. As such, we forecast earnings of AUD 522 million, versus consensus estimates of AUD 537 million. The shares are currently trading at a 16% discount to our intrinsic assessment and are therefore undervalued, in our opinion. Industry sources cite total community pharmacies currently operating under the Ramsay banner as having reached 29, up from 22 at Dec. 31, 2016 and tracking well ahead of our estimates. The pharmacy initiative which was unveiled back in August 2016 is essentially a franchise model (given current regulatory restrictions which limit ownership to practising registered pharmacists) and as such are contingent on signing up existing community pharmacies close to Ramsay's existing hospital sites. Ramsay is targeting around 300 community pharmacies by 2020, which we think is ambitious given current ownership and pharmacy location rules. That said, the Kings review now under way will provide recommendations on future remuneration, regulation including pharmacy location rules, and other arrangements that apply to pharmacies for the dispensing of medicines and other services provided under the Pharmaceutical Benefits Scheme. As such, a deregulation of ownership rules before or by 2020 could see an acceleration of the pharmacy push.

In any case, we remain positive on the strategy, and along with the global procurement initiative and set against 200 existing hospital pharmacy dispensaries already operating across the global hospital portfolio, it leverages Ramsay's substantial purchasing power into pharmaceuticals. Importantly, given the ageing demographic, it also expands the company's hospital-based service model beyond acute settings and into chronic disease management in Australia.

Analyst: Chris Kallos

Westfield Corporation \$7.68

There Is Nothing Democratic with Digital Retail. Westfield FVE cut 11% to AUD 8.90

Recommendation: Accumulate	FY2018 Yield: 4.37%
Intrinsic Value: \$ 8.9	Franking: 0%
Risk: Medium	FY2018 PER: 15.94x
12 mth history: \$7.63 - \$10.85	Market Cap: \$15960m

Tectonic shifts are occurring in the retail sector, and the most impactful will likely remain digital retailers systematically taking sales from brick-and-mortar retailers. Recent innovations by digital retailers plus ongoing high sales growth rates is why we now believe retail landlords and their base rents will suffer more than our prior estimates. Households in developed countries are rapidly changing their retail spending patterns, with the astronomical growth in free delivery, particularly Amazon Prime, being more harmful to landlords than our previous assessment. We've cut our outlook for long-term rent growth particularly for the regional assets, where sales growth has been slowing. Continuation of recent trends indicate societies of the future will have a diminished need for retail space, so we've also cut our outer year expectations for development capital expenditure. Combined, these changes reduce our fair value estimate for narrow moat-rated Westfield by 11% to AUD 8.90 from AUD 10.00. That said, we continue to view Westfield as undervalued, as the damage to the share price looks overdone.

Westfield's portfolio is skewed toward major urban hubs and also those with a wealthier demographic. We see the majority of the firm's assets benefiting from sustained tenant demand. Accordingly, we still think Westfield benefits from sustainable competitive advantages, and retain our narrow moat rating. But we see the sales performance of some tenants, particularly the large apparel category, being further impacted by a continuation of high growth in digital retailing.

Analyst: Tony Sherlock

Resource Stocks

Santos \$3.39

Santos' Cost Focus is Bearing Fruit. Fair Value Upgraded 8% to AUD 5.75

Recommendation: Buy	FY2018 Yield: 3.05%
Intrinsic Value: \$ 5.75	Franking: 100%
Risk: High	FY2018 PER: 13.10x
12 mth history: \$2.87 - \$5.07	Market Cap: \$7061m

We increase our fair value estimate by 8% to AUD 5.75, due to a combination of the time-value-of-money and reduced costs. Santos has guided for yet another decline in free cash flow breakeven, confirming the ability of CEO Kevin Gallagher to match words with action. The updated USD 33 per barrel figure improves on the most recent USD 34 estimate and betters 2016's USD 36.50 figure. Production cost guidance is reduced to USD 8.00-8.25 per barrel of oil equivalent, from USD 8.45 in 2016.

This is pleasingly confirmatory, with lower second-quarter 2017 costs and improved pricing enabling net debt to decline to USD 2.9 billion in line with expectations, down sharply from USD 3.5 billion just six months ago. Net debt/annualised first-half 2017 EBITDA of 2.5 contrasts favourably with 2015's 4.1 level. Net debt could be expunged

within four years, or sooner if no PNG LNG expansion is undertaken. Our fair value estimate equates to a 2026 EV/EBITDA exit multiple of 6.5, assuming a midcycle USD 60 per barrel Brent crude price and crediting one additional PNG LNG train, valued at AUD 0.45 per share, but no expansion to GLNG's two trains.

The market appreciated the news, with Santos shares up 8% on report's release. But at AUD 3.25 we believe there is a long way to go. Gallagher said lower costs "had enabled Santos to increase drilling activity in both the Cooper Basin and across its GLNG acreage" and "additional wells will help boost production over the next few years so Santos can deliver increased gas supply for the domestic market." We view this as important given the threat of the Australian Domestic Gas Security Mechanism to take from exports if shortfalls arise. It also lends support to the core assertion in our June 2017 Santos Special Report "Market Misunderstands Santos' Reserves Position." Confusion over reserves and field life is something we think the market has fretted over, the resolution of which could catalyse for share price convergence to fair value.

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