ORD MINNETT
PRIVATE WEALTH

December 2019/January 2020

ORDS MONTHLY

FUTURE PROSPECTS
BANK ON CHALLENGES

The Australian stock market is on track to notch its biggest calendar-year gain in more than a decade in 2019, with the S&P/ASX 200 Index up 21.1% on a price basis at time of writing.

In this final 2019 edition of the *Ords Monthly*, we recap equities performance in 2019 and set out our broader view of the outlook for 2020.

Globally, Ord Minnett and its global research partner are positive on stocks in 2020. In our view, the typical signals of a peaking market – a rush of high-priced takeover action and a flood of IPOs – are not yet apparent, and we do not see a US recession as likely in a presidential election year.

On the home front, the lowest-ever official interest rate – the benchmark cash rate is at 0.75% – should put a floor under economic growth but does not look like providing enough spark to meet the Reserve Bank's employment and inflation objectives.

Given this, we forecast the central bank will cut interest rates again in February, although we also expect it to inject liquidity directly into the economy via asset purchases, commonly termed quantitative easing, later in 2020.

Our Investment Strategy note starting on page 2 sets out our view.

Hybrid securities have proved to be a very attractive option for many, returning 7% in 2019, and the low interest rate environment should bolster prices of these instruments.

In addition, new prudential capital requirements, which are likely be met by issuing unlisted capital securities, should ensure tight supply of the listed hybrid instruments. See page 4 for this new feature of the *Ords Monthly*.

In corporate coverage, Canada-based convenience retailer Couche-Tard has made a takeover offer for **Caltex** at $34.50 a share, valuing the Australian company at circa $8.6 billion.

The Quebec-based Couche-Tard, which operates more than 13,000 service station and convenience store sites, will likely have to make a better offer to gain traction with the Caltex board, while there are other obstacles. See page 5 for more.

The reporting season for the big three banks with a 30 September balance date disillusioned many in the market.

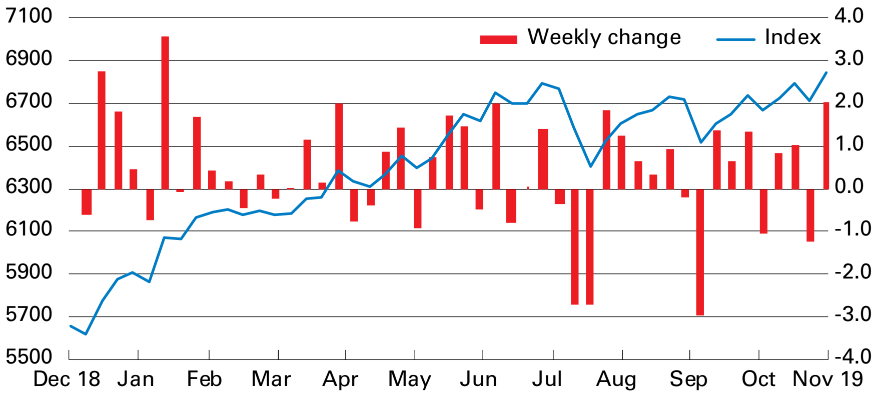
Pressure on interest margins, a weak performance on operating costs and a growing compliance burden just added to the laundry list of challenges facing the industry post the Hayne Royal Commission. Our review of the results starts on page 6.

Meanwhile, **Macquarie** burnished its silver donut with a strong first-half fiscal 2020 profit and a higher-than-expected dividend.

Macquarie is close to fully valued, although given the rocky road faced by the commercial banks, we see plenty of appeal in this high-quality business model. See page 8 for more.

The *Ords Monthly* will return in February 2020. In the meantime, we wish all of our readers the compliments of the season and a happy – and profitable – new year.

Figure 1: S&P/ASX 200 Index weekly performance in 2019 (up to 29 Nov)



Source: IRESS, Ord Minnett Research.

INVESTMENT STRATEGY

LOOKING AHEAD

Australian equities stormed ahead in 2019, with the benchmark S&P/ASX 200 Index up 21.1% to 29 November and on track to notch its first double-digit percentage gain in a calendar year since 2013 when it rose 15.3%.

That robust gain notwithstanding, the local market slightly lagged the MSCI World Index and trailed US benchmarks. The S&P 500 Index has risen 26.4%, and the NASDAQ Composite, is up a stellar 31.6% so far in 2019. See Figure 2 for comparative performances.

Equities as an asset class strongly outperformed other categories in 2019, as per Figure 3, with US and Australian indices striking record highs over the year. We expect this material outperformance to continue in 2020.

In the global picture, Ord Minnett and its global research partner are still positive on equities heading into the first half of 2020, as we see investors still underweight stocks, with fund inflows likely to recover.

Despite equities being around record highs, we do not see the global market backdrop as consistent with typical market peaks.

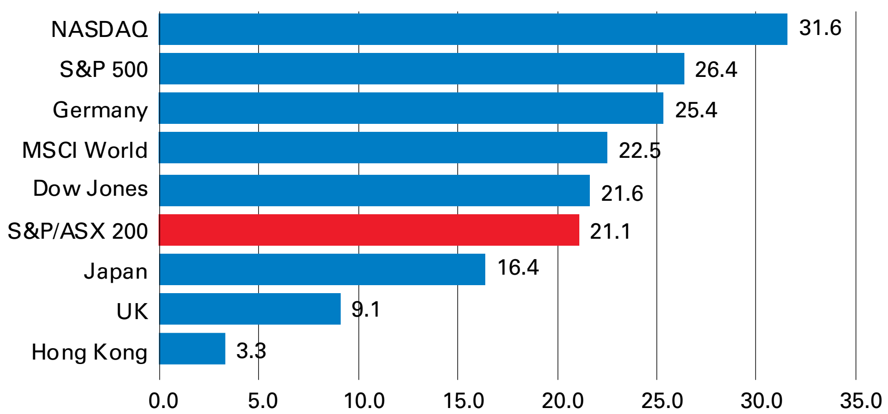
These are usually characterised by a rush of M&A activity at premium prices, a flood of IPOs and significant inflows into stocks.

The current picture is not reflecting this. In fact, US equity mutual funds suffered persistent outflows over 2019 totalling US$250 billion, while bond funds enjoyed significant inflows.

In addition, we see a recession in the key US economy as unlikely over the coming quarters, with the downturn in manufacturing over the past 18 months likely to improve once Washington and Beijing reach a trade truce (although we concede the path to a resolution of the dispute is proving tortuous).

It is worth noting that 2020 is a US election year, and as noted in *Food for Thought: First glance at 2020 US presidential election* on 29 November, in the 12 election years since the 1970s, only two have posted negative price returns in the calendar year leading up to election day.

Figure 2: Global markets performance to 29 Nov 2019 (price basis, %)



Source: IRESS, Ord Minnett Research.

Those two instances of declines were not connected to any political instability or reforms. Rather, one coincided with the dot-com boom and bust, while the other overlapped the global financial crisis – the deepest recession since the Great Depression in the 1930s. This suggests the underlying state of the economy is more important than electoral issues.

Locally, the low-interest-rate environment will dominate the outlook for the economy and markets.

The Reserve Bank of Australia (RBA) has cut interest rates three times in 2019, to 0.75% from 1.5%. Its official commentary concedes current policy settings are unlikely to deliver economic outcomes consistent with the bank's objectives, i.e. full employment and core inflation in the target band of 2–3%.

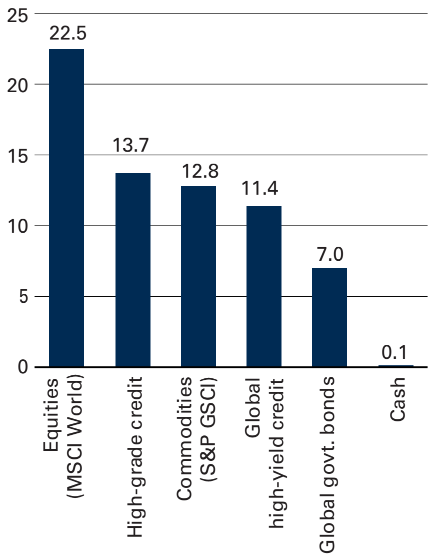
The central bank no longer forecasts a pick-up in wages growth and has pushed its expectation of core inflation's return to the 2–3% band out to 2021, despite 0.75 percentage points of rate cuts this year.

Ord Minnett expects growth in gross domestic product in 2020 of 2.9%, up from our forecast of a below-trend 1.8% in 2019, as the 2019 easings spur investment and modest fiscal stimulus kicks in.

Rising house prices should also help the growth dynamic, via positive consumption effects. We do not expect, however, that the forecast acceleration in growth will be sufficient to deliver inflation and labour market outcomes that are consistent with the RBA's targets.

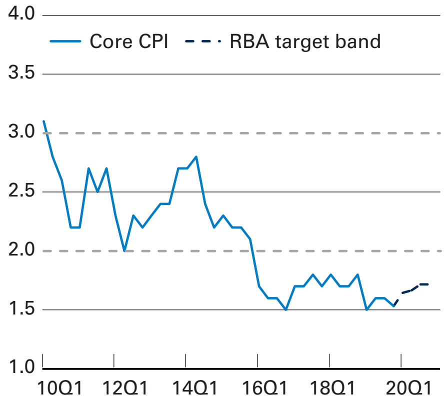
Policy stimulus to date should be enough to stabilise core inflation and prevent a further rise in the unemployment rate, but is unlikely to deliver more than this. See Figure 4.

Figure 3: Global asset class performance to 29 November (%)



Source: Datastream, IBES, Ord Minnett Research.

Figure 4: Australian core inflation versus Reserve Bank target band (%)



Source: Ord Minnett Research and ABS.

We forecast the RBA will cut interest rates again in February, but have also recently added a program of quantitative easing to our estimates.

Quantitative easing, also known as large-scale asset purchases, involves a central bank buying a predetermined amount of government bonds or other financial assets in order to inject liquidity directly into the economy.

It is termed an unconventional form of monetary policy because it is usually applied when inflation is stubbornly low, and conventional expansionary monetary policy (in the RBA's case, the use of the cash rate) has proved ineffective.

Central banks implement quantitative easing by buying specified amounts of financial assets from commercial banks and other financial institutions. This raises the prices of those financial assets and lowers their yield, while simultaneously increasing the money supply.

The main stocks to have benefited from the shift to lower interest rates are mainly those in the bond-proxy sectors, such as infrastructure and property trusts, along with some utility stocks.

Other sectors, such as growth stocks, have been supported by the reduction in risk premiums, which underpins a greater value being placed on profits earned in later years, including healthcare and technology stocks.

The benefits of lower interest rates for households have also seen a lift in consumer stocks.

On the other hand, banks have struggled with lower rates undermining net interest margins (the difference between rates on deposits and money lent out).

More on this, and other challenges facing the banks, on page 6.

FIXED INCOME

FILLING THE INCOME GAP

The listed hybrid securities market has gathered momentum, delivering 7.2% (6.0% excluding the franking benefit) since the start of the year, with most of the gains accruing since the federal election in May.

The Coalition's surprise victory coincided with a series of rate cuts from the Reserve Bank, spurring the prices of these securities higher as many investors sought to rotate out of cash into riskier assets to replace lost portfolio income as a result of declining term deposit rates.

Implications of a lower interest rate environment

Typically, lower interest rates have a positive effect on the price of fixed income instruments given the inverse relationship between price and yield (bond prices rise when interest rates fall).

Importantly for hybrids, the income received is determined by a fixed margin which is added to a reference rate, the bank bill swap rate (BBSW).

The BBSW reflects changes in the cash rate, which in recent years has declined as the macro backdrop has deteriorated. This trend has been particularly pronounced over the past 12 months as the Reserve Bank has reversed the course of monetary policy, shifting to an easing bias early in the year before cutting the cash rate by 75 basis points.

For hybrids, this has translated into lower income generated by hybrid securities, with the average cash distribution rate on major bank hybrids compressing by around 70 basis points to 3.4% over the past six months, reflecting changes to the local policy rate.

However, one of the most meaningful return indicators in fixed income is a security's yield to maturity – the annualised return of a security if purchased today and held to its maturity date, collecting all payments along the way.

On this metric, there has been a meaningful decline, with the average total return on a five-year major bank hybrid sliding almost 1 percentage point to 3.8% (inclusive of franking) since the central bank began easing in June.

Our economists forecast an additional 50 basis points in rate cuts over 2020, which could place further downward pressure on yields.

However, with the RBA expected to engage in large-scale asset purchases by the end of next year, this could provide further support to the outlook for the prices of hybrid securities as investors continue to step up the risk curve.

Another measure used to evaluate hybrid securities is the gross running yield, which, in some ways, is similar to the dividend yield on an ordinary share. It represents the rate of return an investor could achieve by purchasing the security today and collecting the next year's worth of cash distributions and franking credits.

This measure is different to yield to maturity because it does not take into account any capital gains or losses. Although the gross running yield on major bank hybrids has declined by around 1.5 percentage points over the last year, the average gross running yield on a major bank hybrid still offers investors a relatively attractive return of 4.5%.

Outlook

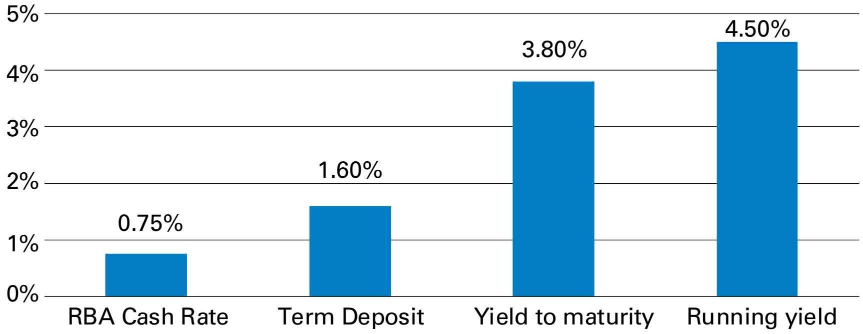
In the medium to longer term, there are several tailwinds for the sector:

- Major bank hybrids were recently upgraded to investment grade by global ratings agency Standard & Poor's, thereby increasing their appeal for institutional investors.
- Further cuts to the cash rate will improve the relative appeal of hybrids, bolstering price support.
- Additional capital requirements are likely to be raised in the form of tier-two capital in the unlisted market which should perpetuate supply pressure in tier-one hybrids.
- Ongoing work by regulators to reduce risk-taking within banks should increase the creditworthiness of issuers.

We continue to see attractive risk-adjusted returns within the hybrids market, with falling interest rates, broader derisking of bank balance sheets and increases to capital requirements positioning this asset class for continued strength into the new year.

Please contact your Ords adviser for more information on hybrid securities.

Figure 5: Comparison of yields on term deposits and major bank hybrids



Source: Bloomberg. Ord Minnett estimates. Yield to maturity and running yield are annualised returns on major bank hybrids with approximately five years to call.

CALTEX AUSTRALIA

CANADA COMES CALLING

Sector: Energy Recomm: Hold Risk rating: Higher Share price: $34.56

Year to December	2018A	2019E	2020E
Profit after tax ($m)	558.3	346.9	484.5
Earnings per share (¢)	214.1	135.9	194.0
Price/earnings (x)	16.1	25.4	17.8
Dividends per share (¢)	118.0	78.0	112.0
Dividend yield (%)	3.4	2.3	3.2
Franking (%)	100	100	100

Source: Company reports, Ord Minnett Research. Profits are on a normalised basis.

Caltex Australia (CTX) share price

Source: IRESS

Canada-based convenience retailer Alimentation Couche-Tard has made a conditional takeover offer for **Caltex Australia** $34.50 a share, valuing the local company at around $8.6 billion.

Caltex has rejected the bid, which followed an earlier offer at $32.00 a share, as inadequate.

The conditions include due diligence (since granted on a limited basis), organising financing, no material asset sales, divestments or similar transactions, obtaining Foreign Investment Review Board (FIRB) approval, and unanimous recommendations by both companies' boards.

Importantly, Ord Minnett notes the Couche-Tard offer would permit a special dividend to be paid, allowing Caltex to distribute the $800 million in franking credits it held as at 30 June, or around $3.20 a share.

The Quebec-based company, founded by Alain Bouchard in 1980, has a market capitalisation of US$36 billion. It owns more than 13,000 service station and convenience store sites around the globe, with its primary brand being Circle K.

Complicating the issue is Caltex's planned spin-off of its freehold service station and retail sites. The spin-off would see Caltex sell off a 49% interest in 250 core convenience retail sites.

The sites would be placed in a property trust, and Caltex would then enter into long-term lease agreements over each site. Rental payments would be $80–100 million in the first year, with completion of the IPO in the first half of calendar 2020.

We value the property IPO at around $1.9 billion, based on a 4.75% capitalisation rate, with $704 million in post-tax proceeds for Caltex.

It is clear a higher indicative bid, and/or one with fewer conditions, or perhaps a break fee, will be needed to bring Caltex to the table.

Further, the timing of the property IPO announcement – a sound but not yet fully formed proposal that is still subject to final Caltex board approval – the day before the bid was revealed creates the impression of Caltex adopting a hard-nosed approach.

Notwithstanding Caltex's view on what constitutes a sufficiently attractive price, the biggest obstacle to the offer proceeding may be winning federal government approval via the FIRB.

This is due to the irreplaceable network of Caltex's strategically important infrastructure and terminal assets, such as the Kurnell terminal in Sydney with its deep-water access and pipelines to the airport, western Sydney and Newcastle; and the Lytton refinery in Brisbane, one of only four remaining in the country.

Media reports suggest Couche-Tard may be seeking a partner to take the infrastructure and refining assets, which are less of a focus for the Canadian company than convenience retailing.

We see this option as unlikely, however, given Caltex's performance as an integrated fuels business is enabled by its infrastructure assets, thus making a successful asset separation a difficult process.

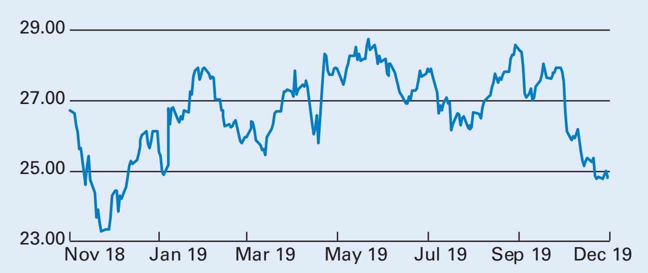
BIG 4 BANKS

MARGINAL PERFORMANCE

ANZ Bank – Recomm: Hold Risk rating: Medium Share price: $24.84

Year to September	2019A	2020E	2021E
Profit after tax ($m)	6,470.0	5,842.9	6,422.3
Earnings per share (¢)	218.1	197.8	215.1
Price/earnings (x)	11.4	12.6	11.6
Dividends per share (¢)	160.0	160.0	160.0
Dividend yield (%)	6.4	6.4	6.4
Franking (%)	90	70	70

ANZ Bank (ANZ) share price



Commonwealth Bank – Recomm: Hold Risk rating: Medium Share price: $80.82

Year to June	2019A	2020E	2021E
Profit after tax ($m)	8,492.0	8,567.5	8,836.4
Earnings per share (¢)	464.4	469.9	488.8
Price/earnings (x)	17.6	17.4	16.7
Dividends per share (¢)	431.0	431.0	431.0
Dividend yield (%)	5.3	5.3	5.3
Franking (%)	100	100	100

Commonwealth Bank (CBA) share price

National Australia Bank – Recomm: Accumulate Risk rating: Medium Share price: $25.89

Year to September	2019A	2020E	2021E
Profit after tax ($m)	5,097.0	6,433.6	6,720.1
Earnings per share (¢)	177.0	212.7	218.6
Price/earnings (x)	14.8	12.3	12.0
Dividends per share (¢)	166.0	166.0	166.0
Dividend yield (%)	6.3	6.3	6.3
Franking (%)	100	100	100

National Australia Bank (NAB) share price

Westpac – Recomm: Hold Risk rating: Medium Share price: $24.52

Year to September	2019A	2020E	2021E
Profit after tax ($m)	6,849.0	7,384.8	7,459.8
Earnings per share (¢)	191.4	200.5	198.3
Price/earnings (x)	12.9	12.3	12.5
Dividends per share (¢)	174.0	160.0	160.0
Dividend yield (%)	7.0	6.5	6.5
Franking (%)	100	100	100

Westpac (WBC) share price

Source: Factset, IRESS, Ord Minnett Research. Profits are on a normalised basis.

Fiscal 2019 and second-half results from the big three banks that rule off their books on 30 September proved very disappointing.

The season was characterised by weaker-than-expected net interest margins and costs that proved hard to budge, which drove, on average, a 3% miss to our pre-provision forecasts.

Combined with subdued outlooks for interest margins in this low rate environment and asset growth, along with 'sticky' costs, the upshot of reporting season is unusually large estimate downgrades of circa 6%, on average, in fiscal 2020 and 2021.

Divisionally, retail banking performed better than the other divisions. This was mainly due to tailwinds from cheaper wholesale funding costs, however, we expect this will likely prove to be a flash in the pan.

Business banking operations delivered broadly as expected, while non-interest income was mixed, with markets and treasury income weaker.

Asset quality trends remained broadly benign, with bad and doubtful debts still very close to cyclical lows. Only **Westpac** was up materially, albeit from unsustainably low levels.

This was slightly better than we had expected, having assumed a continuation of the June-quarter trends. We continue to forecast a gradual uplift in bad debt charges over the next three years, reaching 0.2% of gross loans and advances by fiscal 2022, up from current levels of 0.13–0.17%.

We examine the key themes in further detail below:

Interest margins

Underlying net interest margins fell 4bp half-on-half (HoH) for **ANZ**, 1 basis points (bp) for **National Australia Bank** and 2bp for Westpac.

To give a true sense of underlying margin pressure, we need to strip out of the benefit from lower wholesale funding costs. On this basis, we estimate Westpac's margin declined 7bp HoH, ANZ's fell 6bp, and NAB's narrowed 3bp.

The net interest margin outlook remains challenging, reflecting the full period impacts of cash rate cuts by the central bank and ongoing competitive pressures in mortgages.

We have incorporated a further 0.25 percentage point cut in the cash rate to 0.5% in February 2020, of which we assume banks will hold half back from variable rate mortgage customers.

Costs

The banks delivered a much weaker cost performance in the second half of fiscal 2019. Underlying costs increased for all three banks that reported by 1–2%, wiping out much of the savings made in the first half.

Regulatory and compliance costs were the dominant theme, alongside expenses for the new rules imposed by the New Zealand central bank, and rising amortisation charges.

Cost targets were largely maintained, although confidence in these has fallen and goals of absolute cost reduction in the sector now appear to be medium-term targets rather than near-term prospects.

Remediation charges

We estimate the major banks have recognised $8.1 billion in total remediation charges since fiscal 2014, with a large step up in fiscal 2019.

The banks have all said they have fully provided for 'all known issues'. Their internal reviews continue, however, and we see potential for further provisions. As such, we have included more remediation charges for ANZ and **Commonwealth Bank** in fiscal 2020.

Westpac is a major risk in this area, given its current civil charges over alleged breaches of anti-money laundering regulations.

The charges have already claimed CEO Brian Hartzer, chairman Lindsay Maxsted and risk committee chairman Ewen Crouch, with potentially more to come as acting CEO Peter King moves to repair the damage wrought by the scandal.

We have not yet factored in a possible penalty in our forecasts, given the difficulty in estimation, but do note the primary precedent is CBA's $700 million settlement with the Australian Transaction Reports and Analysis Centre in 2018.

Commonwealth Bank

The first-quarter fiscal 2020 trading update from CBA showed surprisingly strong trends due to solid lending growth in mortgages and business lending, an apparently flat net interest margin and a strong rebound in non-interest income.

We note, however, that non-interest income was boosted by one-off items and loan growth is likely to slow, particularly mortgages, while, as with its rivals, a tailwind from wholesale funding costs flattered its net interest margin.

Outlook

NAB remains our preference among the major banks (and our only Accumulate recommendation) in what is unquestionably a very challenging period for the sector. CBA is our least preferred option in the big four as it looks expensive on a fiscal 2021 price-earnings multiple of 16.7 times.

MACQUARIE GROUP

DONUT KING

Sector: Financials Recomm: Accumulate Risk: Higher Price: $138.05

Macquarie Group (MQG) reported a first-half fiscal 2020 cash net profit of $1.457 billion, up 11% on a year ago and 1% ahead of Ord Minnett's forecast. A 40% franked interim dividend of $2.50 a share was declared, above our $2.30 estimate.

Trading income from the commodities and global markets business, and base and performance fees from the infrastructure real assets division were strong, which was a pleasing result given these are two core businesses for Macquarie.

Meanwhile, Macquarie Capital was quite a bit weaker than expected, due largely to lower debt capital market revenue and higher costs due to accelerated amortisation of previous years' equity awards for retiring executives.

That said, we expect Macquarie Capital's performance and returns to improve in the second half of fiscal 2020 and into fiscal 2021 as debt market conditions normalise and investment impairments fall.

In addition, the benefits from capital deployed into the booming green energy market should start to come through.

We continue to expect 2% net profit growth in fiscal 2020 versus guidance of *"slightly down"* on fiscal 2019.

There are no changes to our net profit forecasts for fiscal 2020 and 2021, although we have trimmed our fiscal 2022 estimate marginally.

Given a solid share price rise ahead of the result, Macquarie no longer looks overly cheap. The stock is trading at 15.6 times forecast fiscal 2021 earnings and there is only modest potential upside (circa 4% including dividends) to our valuation.

Given the challenges facing the commercial banks, however, we still see some relative appeal in what we consider a high-quality company, leading us to maintain our Accumulate reccomendation.

For the full report, please contact your Ord Minnett adviser.

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