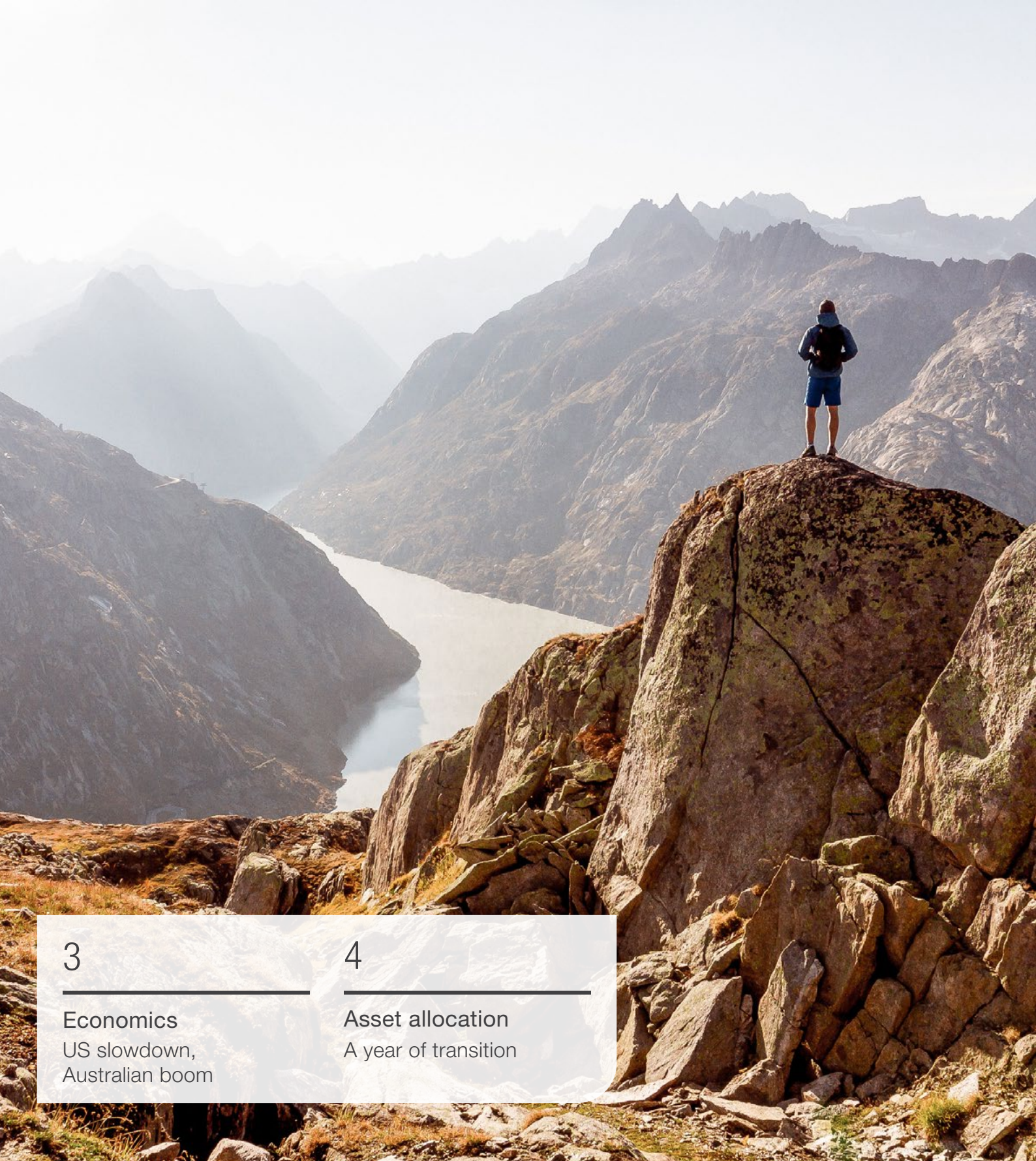


# Investment Watch



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Economics

US slowdown,  
Australian boom

4

Asset allocation

A year of transition

# Welcome

As inflation rates surge to multi-decade highs, central banks have started what we expect to be the most aggressive cycle of interest rate increases since the late 1980s/early 1990s. The spectre of significantly higher interest rates has sent shockwaves through global markets as investor concerns grow that efforts to rein in inflation will end in recession.

In this edition we explain why global recession is not our base case and despite the expectation for further market volatility over the next six months, we think below-trend growth will be the likely outcome. We update our asset allocation and tactical positioning maintaining a defensive tilt to portfolios. At a sector level, we prefer resources and defensive industrials and remain vigilant for buying opportunities amidst the noise.



**Richard Blomfield**

Portfolio Analyst and  
Financial Planner

BBus MAppFin DFP  
AR: 001002547



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## Recently published research

<a href="#">Equity strategy - Q3 2022 Sector Outlook and Strategies</a>	1 July
<a href="#">Equity strategy - Morgans Best Ideas</a>	1 July
<a href="#">Investment strategy - Asset Allocation Q3 2022</a>	1 July
<a href="#">Morgans Model Portfolios – Morgans core and growth equity portfolios</a>	20 June
<a href="#">Economic strategy - Watch the RBA copy the Fed</a>	18 May

# Economics

## US slowdown, Australian boom

In this issue, we look at what the Federal Reserve is attempting to do and the result of its actions.

The Fed's Summary of Economic Projections of 15 June charts a course to slow the US economy to below trend growth. It estimates that trend growth in the US economy is a GDP growth rate of 1.8%. By engineering a slowdown, the Fed is in effect moderating the annual growth in the labour force, plus productivity growth.

What the Fed is attempting to do is slow the US economy to below trend growth rate, so that rising unemployment will put downward pressure on inflation. They think they will be successful in reducing inflation from 5.2% (PCE inflation) in 2022 to 2.2% in 2024. Most importantly, they believe they will achieve this fall in inflation without the US falling into periods of negative GDP growth. This means they believe there will be no US recession.

The question is, how will we know that they are being successful in avoiding recession? We refer to the Chicago Federal Reserve National Activity Index. This is a broad measure of the US economy. It has 85 different indicators of economic activity that are updated every month. The scale of the index is in standard errors. When the US economy is growing at long-term trend levels, the index is at a level of zero. This would now be equivalent to a GDP growth rate of 1.8%.

When US GDP is falling, the Index is below -0.7. At that point, the US economy is in recession. So, where is the US economy now? Back in April 2022, the three-month moving average of the Index stood at 0.48. This means that US growth was still strong enough to be putting upward pressure on inflation. In May, the three-month moving average of the Index fell to 0.2. This is still above-trend growth, but not strong enough to be adding to inflation.

This reading is far above what would indicate a US recession. We can say with great confidence that the US economy is not in a recession. Importantly, we can check progress of the Federal Reserve by looking every month at the Chicago Fed National Activity Index. This can be found at [chicagofed.org](http://chicagofed.org).

### The path for interest rates?

In order to achieve the Fed's economic objective, the Summary of Economic Projections suggests the Fed Funds rate will rise to 3.4% by the end of 2022. This suggests a Fed Funds rate band of 3.25% to 3.5%. The effective Fed Funds rate would be just below 3.35%. There is no Fed meeting in either August or October. Meetings are in July, September and the beginning of November. The Fed could achieve this November interest rate of 3.35% with two 50 basis point rate hikes and one 75 basis point rate hike. The order of these rate hikes is of course entirely up to the Fed to decide.

Were the RBA to match this rate of increase, which is our base case, it would need to have a rate hike of 50 basis points in the August, September, October and November meetings. Should it do this, then both the Fed and the RBA would have an official short rate of 3.35% by the end of the first week of November 2022.

The Fed is attempting to slow the US economy to below trend growth rate, so that rising unemployment will put downward pressure on inflation. Most importantly, they believe they will achieve this fall in inflation without the US falling into periods of negative GDP growth.

We are currently living through one of the greatest commodity booms in Australian history.

In the most recent outlook for the Australian economy, released by the Reserve Bank of Australia in May 2022, the RBA thought the Australian economy in 2022 would grow by 4.25%. The Australian economy is in a strong period of economic growth bolstered by very strong commodity prices. There is no chance of Australia approaching a recession any time soon given the strength of current economic fundamentals.

We note that such a path of interest rates in each country would be dependent upon the flow of data coming forward independently to each central bank.

### Conclusion

The Fed is attempting to slow the US economy to below trend growth rate, so that rising unemployment will put downward pressure on inflation. Most importantly, they believe they will achieve this fall in inflation without the US falling into periods of negative GDP growth.

The US economy is not in recession. What we believe will occur as the Fed slows the US economy to below trend growth, is that the level of the National Activity Indicator will fall into a range that is below zero but above -0.7. The US economy will slow but avoid recession.

	Morgans (CY22)	Consensus (CY22)
GDP Growth	4.3%	4.0%
Inflation	6.0%	5.8%
RBA Cash Rate	3.4%	2.4%
AUD	74c	73c
ASX 200	7100	7700

Source: Morgans, Bloomberg

For more economic coverage subscribe to our podcasts



# Asset allocation

Q3 2022 update

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Much has changed since our last update: an energy shock, sharp interest rate hikes and a weaker global macro outlook. We have reduced our portfolio risk-taking as a result and brace for market volatility ahead.

Tactically we favour domestic equities and real assets with a clear bias for quality. Short-term opportunistic risk hedges (currency, gold) are another option to navigate the uncertainty.

We retain a preference for inflation protection with escalating prices unlikely to unwind given the supply-chain challenges and higher energy costs.

## The unease in financial markets

As inflation rates surge to multi-decade highs, central banks have started what we expect to be the most aggressive cycle of interest rate increases since the late 1980s/early 1990s.

The spectre of significantly higher interest rates has sent shockwaves through global markets as investor concerns grow that efforts to rein in inflation will end in recession.

Recession is not a foregone conclusion, but monetary policy tightening is upon us. Investors are thus advised to keep duration short on both equity and fixed income.

We think the rises in global government bond yields and falls in equity prices have a bit further to run. Government bond yields have typically peaked only shortly before the end of central bank tightening cycles and we expect most major central banks to continue hiking rates over the next 12 months. We think the increase in government bond yields, as well as the threat of slowing global economic growth, will keep risk assets such as equities under pressure.

This environment may see some continued widening in credit spreads. We suspect markets will only start to turn a corner later this year as tightening cycles near terminal levels.

## Maintaining a home bias

Tactically we prefer a portfolio closer to home with economic conditions holding up and inflation concerns less acute than global peers. In our view, strong employment conditions will provide an offset against a backdrop of falling house prices and weaker consumption. However, we remove our overweight to Australian equities this quarter acknowledging the near-term risks.

While we do see ongoing risk to core assets equity and fixed income, we see an allocation to alternative assets as a way to diversify portfolio risk.

## Key changes to our asset allocation settings

We cut risk exposure this quarter maintaining an underweight to global equities. Despite the recent pullback, valuations in the US remain elevated and higher energy costs in Europe will constrain growth. We cut Australian equities back to neutral. The resilient earnings outlook assisted by higher commodity prices, in our view, will see Australia outperform global peers, but Australia is not immune to the inflationary backdrop. We overweight cash as we see the risk of heightened volatility over the next few months.



## Global Equities

### Recommendation



### Comment

Tactically we are underweight global equities due to a higher risk of central banks overtightening policy and a deteriorating growth backdrop in China and Europe. Despite the sharp fall in the US stock market this year so far, US equities still appear much more highly valued than their peers across the rest of the world. While that might not tell us much about the outlook for relative returns in the near term, comparatively high valuations in the US are perhaps a reason to suspect the US stock market will underperform those elsewhere over the next 12 months.

## Australian Equities

### Recommendation



### Comment

We pull our tactical position back to neutral as we see ongoing volatility from higher interest rates and a moderating pace of economic growth will challenge returns in the short term. As tailwinds from commodity prices and the post-pandemic reopening start to ease, we think above-average earnings growth for the market will be harder to come by. Accordingly, we prefer a targeted portfolio approach favouring reflation (financials, energy) and quality cyclicals with strong market positions that can absorb rising costs.

## Fixed Income

### Recommendation



### Comment

We are neutral fixed income (underweight previously) as term deposit rates have improved from low levels.

## Property and Infrastructure

### Recommendation

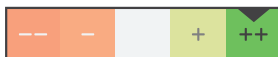


### Comment

We believe that infrastructure assets, with their reliable earnings that are protected to a degree from inflation, are an attractive long-term investment proposition. But higher interest rates can be expected to lead to a higher cost of debt and an increase in the rate at which investors value future earnings. We see listed property as trading close to fair value. Whilst earnings growth is likely to be strong as economies recover from the scars of COVID-19, we believe the property market will likely remain susceptible to movements in bond rates in the short to medium term. We prefer a more defensive exposure to the asset class (storage, essential services).

## Cash

### Recommendation



### Comment

With global short interest rates trending higher and conditions in place for a return of pricing volatility, we see the need to build up some dry powder. Though current cash rates remain a drag on real returns, it does provide a necessary buffer against a period of elevated market risk.



# Equity strategy

## Stick to the fundamentals

Morgans research analysts reset their sector views, strategies and best ideas as markets adapt to new financial and geopolitical challenges.

### Equity portfolio construction

The short-term performance of Australian equities will likely see ongoing volatility from higher interest rates and a moderating pace of economic growth will challenge returns in the short term. As tailwinds from commodity prices and the post-pandemic reopening starts to ease, we think above average earnings growth for the market will be harder to come by.

We prefer a targeted portfolio approach favouring reflation (financials, energy) and quality cyclical with strong market positions that can absorb rising costs. In this note, Morgans analysts see solid opportunities among **consumer staples, healthcare, financials and materials/energy**.

We continually seek to rebalance equity portfolio exposure to all of yield, value, cyclical and growth factors.

Ultimately, we're looking for best-of-breed companies capable of thriving regardless of the macro-economic backdrop.

### Key sector outlooks

Category	Sector	Rating	Overview
Financials	Banks		In the absence of material asset quality deterioration, we expect bank dividends to remain reasonably robust. However, bank dividend yields may become incrementally less attractive on a risk-adjusted basis relative to government bonds, bank hybrids and term deposits.
	Diversified Financials		We continue to see the relative appeal of diversified financials stocks. Our overall sector view is driven by strong stock balance sheets, reasonable valuations, relatively defensive sector earnings streams and generally positive sector leverage to rising interest rates.
Defensives	Consumer Staples		The defensive characteristics of the sector provide a solid anchor against the impacts of tight supply chains, persistent inflation, rising interest rates and pressure on household budgets.
	Healthcare		The sector appears to have turned the corner, as investors focus on high quality parameters, favourable fundamentals and low beta appeal in a world awash with uncertainty. We maintain a moderate overweight rating for investors looking for a safe haven in a storm.
	Telco		Demand for digital infrastructure supporting Cloud, automation and digital efficiency remains strong. Select companies should continue to grow despite the challenging economic environment.
	Infra and Utilities		Essential service providers with regulated revenues, resilient demand, or long-term contracted earnings with low correlation to the economy remain in-demand. Scarcity of assets, takeover activity and the inflation hedge add to the appeal of the sector.
	A-REITs		Capital performance will fluctuate with bond rate expectations, however REITs continue to offer attractive distribution yields with the sector average +5%.
Cyclicals	Consumer Discretionary		Consumer confidence/expenditure will likely track lower in coming months due to pressure on household budgets. Sector valuations look more compelling on a medium-term basis, although we expect short-term volatility in pricing and sentiment.
	Industrials		Industrials have so far pushed price increases without a noticeable demand impact. Defensive companies exposed to food, beverages, healthcare and repairs and maintenance activity are best positioned to benefit as households look to reduce spending in other areas.

Cyclicals	Online		Valuation multiples have reverted below average historical levels. In the current climate, we prefer a tilt towards higher quality, free cash flow generating names, although acknowledge the opportunity in some smaller cap names with large growth pathways ahead.
	Technology		Selective exposure to technology stocks is likely to deliver value due to their ability to grow earnings faster than GDP, regardless of interest rate movements. We prefer high quality, cash-generative technology companies with net cash balance sheets and pricing power.
	Agriculture		Strong seasonal conditions combined with higher soft commodity prices (economic deflation, USD weakness) combine to offer solid sector tailwinds through 2022. We do caution though that a sector sell-off may follow the roll-off of record seasonal conditions.
Resources	Metals and Mining		The sector should benefit from upweighting by generalist investors recognising that inflationary forces and current geopolitics are powerful tailwinds, provided that a global downturn in demand can be averted.
	Energy		We think broad sector underperformance has been driven by local energy stocks' large exposure to upstream, which requires greater conviction in prices. We expect strengthening oil/gas prices to drive a gradual rerating in Australian energy stocks.

## Banks

### Rising cash rate and implications for earnings and dividends

Net interest income generally accounts for c.80% of bank revenues. Increases in the RBA cash rate support the outlook for net interest margins (NIM), through interest rate-insensitive deposits and free funds. Furthermore, NIMs will benefit from waning demand for fixed-rate home loans (which are generally lower margin) relative to variable rate home loans, as fixed rates on offer have normalised.

Offsetting these NIM tailwinds is the likely rise in the average cost of funds, as a result of refinancing drawings on the RBA's ultra-cheap Term Funding Facility with far more expensive wholesale debt, rising costs of wholesale debt (both bank bills rates and credit spreads), increases in term deposit rates, a reversion of funds from at-call deposits to term deposits and a reduction of deposits on bank balance sheets. In addition, intense competition sees margins on new loans below those on loans outstanding.

While recent reported credit growth (both home loans and business) has been strong, higher interest rates may slow credit growth. However, we expect the banks to be better poised to win back home loan market share from the non-bank lenders in a rising interest rate environment.

Fears of significantly higher interest rates have put downward pressure on asset prices and increased risk of rising unemployment (albeit from very low levels). It also puts pressure on household budgets that have already been impacted by higher grocery and fuel costs. As such, bank asset quality, which has been around all-time highs, should be expected to deteriorate to more normal levels.

Banks continue to focus on cost efficiencies, albeit labour shortages and rising wage inflation make this task difficult.

In the absence of material asset quality deterioration, we expect bank dividends to remain reasonably robust. However, dividend yields may become less attractive on a risk-adjusted basis relative to interest rates on government bonds, bank hybrids, corporate debt and term deposits. Given regulatory capital levels are relatively close to APRA requirements, future buyback activity seems predicated on further asset sales.

### Recent publications

#### Banks

With the RBA set to dance, we take a cautious stance.

[Read publication](#)



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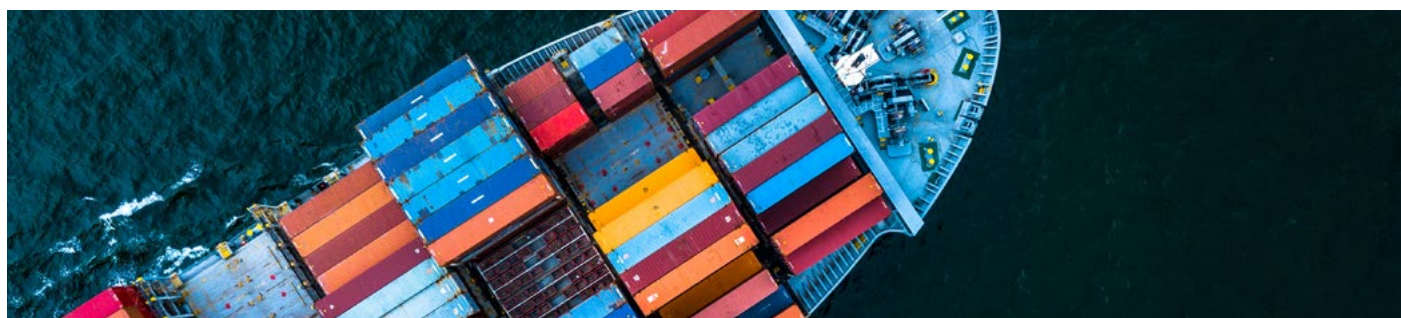


# Industrials

## Playing defence

Inflation has been running hot for some time and remains a headache for central banks around the world as policymakers increase interest rates to slow the pace of price growth. With global factors, including COVID-related disruptions to supply chains and the war in Ukraine, driving up prices for key business inputs such as raw materials and logistics, Industrials companies also have the tricky task of balancing costs and revenues. Throw into the mix labour shortages and there is a lot for management teams to think about.

The operating environment remains volatile and with ongoing uncertainty around inflation, we think it is best to stick with companies that have defensive characteristics and pricing power. Companies that are exposed to food, beverages, healthcare and repairs and maintenance activity should continue to perform well as the products and services they provide are necessities. These businesses are in a good position to benefit as cost-of-living pressures increase and households look to crimp spending in other areas.



# Resources and Energy

## A tough quarter

June proved to be a much more volatile quarter for resource stocks and commodities. Key commodities iron ore, oil and gas were roughly steady. Iron ore was supported by resilient low-side steel production in China, despite a sharp COVID impact to China's economy during the period, while oil and gas (domestic gas and LNG) prices remain well supported at elevated levels by ongoing supply tightness, which we believe can continue in the second half of 2022. The worst performance surprisingly came from base metals, with aluminium (-32%), copper (-18%), lead (-16%), zinc (-15%) and nickel (-32%) all down during the June quarter.

This price weakness came despite a continuing drawdown in LME stockpiles across base metals (ex tin). We believe the apparent supply deficit across these metals, versus their unexpected price weakness, is best attributed to weakness in futures markets from commodity traders expecting US dollar strength, a second half slowdown in global manufacturing and COVID impact to China's economic recovery. While these factors should play a role in pricing commodities, we are encouraged by the key price weakness appearing to come from speculation, while prevailing fundamentals remain much healthier.

## Recent publications



**Cleanaway Waste Management**  
**HOLD TP A\$2.79**  
Deep dive session: strategic infrastructure growth

[Read publication](#)



**Amcor**  
**ADD TP A\$18.60**  
Focusing on higher value markets

[Read publication](#)

## Recent publications



**BHP**  
**ADD TP A\$48.30**  
Rebasing expectations post demerger

[Read publication](#)



**Woodside Energy**  
**ADD TP A\$32.90**  
Deal greatly enhances fundamentals

[Read publication](#)

# Consumer discretionary

## Under the pump

When the RBA increased its target rate by 50 bps to 0.85% in June, its governor indicated the action was needed to get inflation back towards target levels. The Australian CPI increased to 5.1% in the March quarter. The RBA expects it to rise further to 5.9% later this year, before falling back towards 2-3%, though many people believe this to be a conservative assumption. The rising prices of fuel, electricity, gas and food have started to impact consumer confidence. While household savings remain elevated and unemployment low, it seems inevitable that Australians will seek to rein in discretionary expenditure as the cost of day-to-day necessities rises.

Weakening consumer demand comes at a time when many retailers are experiencing substantial rises in input costs. Staff represent a major expense for many and a tight labour market will put further upward pressure on wages. The cost of freight (most Australian retailers are importers) has been high for a while and is yet to moderate. Higher fuel and energy costs are adding to the pressures. It all adds up to the likelihood of negative earnings momentum across the sector.

These issues have not gone unnoticed by investors. On average, the share prices of ASX-listed discretionary retailers have fallen by more than 50% from their 12-month highs. The median FY23 P/E ratio for this group of stocks is now less than 9x, which even allowing for downside risk to consensus earnings as we move through the August reporting season, suggests many may have been oversold. Expect a bumpy ride as earnings expectations stabilise, but we believe it is worth seeking out stocks with medium-term growth potential at what may be compelling prices.

# Infrastructure

## Unlisted raids continue

M&A activity in the ASX-listed infrastructure sector has continued, with IFM Investors indicating it may be interested in taking over Atlas Arteria after having accumulated a 15% economic interest in the stock. This adds to the completed takeovers of Sydney Airport, Spark Infrastructure and AusNet Services over the last 12 months.

We think ASX-listed infrastructure continues to appeal to unlisted investors, given the attractiveness of Australia as an investment destination (regional economic growth, political stability, legal/property rights), the significant capital being allocated by investors to the sector, the limited infrastructure opportunities available to deploy this capital and the lower valuation multiples that listed assets trade at versus the private market. The increased allocation of capital to the sector is due to investors recognising the structural growth opportunities, resilience of cashflows, long-life nature of assets and strong balance sheets. These attributes dovetail with the long-dated liabilities of superannuation and offshore pension funds.

Share prices of the sector's 'survivors' have been resilient compared to broader market weakness. Of note is that the sector has been able to resist the valuation and sentiment headwinds typically associated with rising government bond yields. As well as the factors discussed above, we think this is because of inflation-linked revenues (noting significant spikes in CPI both domestic and offshore), the scarcity value of remaining exposures and investors positioning for potential M&A.

At current prices, we think the space is trading at or above fair value, but its earnings resilience during a period of economic uncertainty justifies continued holding in a portfolio.

## Recent publications

Australian Retail Sales -  
May 2022: Vertigo

[Read publication](#)

## Recent publications

 Transurban

**Transurban**  
**ADD TP A\$14.42**  
3Q22 traffic, 95 Express Lanes,  
WCX capital release

[Read publication](#)

 atlasArteria

**Atlas Arteria**  
**HOLD TP \$8.10**  
Another infra player gets a  
(likely) bid

[Read publication](#)

# Property

## Open for business

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The listed property sector has significantly under-performed the broader market due largely to expectations and the reality of rising interest rates. The Australian 10-year bond yield has seen some rapid moves since the start of the year and is currently sitting at around 3.8%. In response, REITs have seen some large price moves with many currently trading at discounts to NTAs despite asset prices remaining resilient. Given the expectation of higher interest rates, the market is factoring in the likelihood that cap rates will expand, although offsetting this to some degree will be the REITs ability to grow rental income via inflation-linked leases or value-add via development and leasing. We note that the REIT sector has also historically been a good hedge for higher inflation given rising income/rent. Fee income streams may also be impacted from lower asset values and transactional activity (potential impact to fund managers).

As we approach reporting season, many REITs have reiterated or upgraded FY22 guidance. June revaluations announced to date have also been stable/positive across a range of sub-sectors. Traditional retailers are also seeing improvement in rental collection and leasing post the exit of COVID-19 lockdowns. As full year results are delivered in August we expect to see most REITs issue FY23 guidance with the market likely to focus on outlook statements; ability to leverage higher inflation via rent increases; as well as debt tenure, interest costs and hedging profiles given the current environment. While there is an acknowledgement that interest rates are heading higher, balance sheets are largely sound (most REITs are currently hedged at 50-60%).

Given the large number of REITs trading at discounts to NTA, many groups continue to undertake security buy-backs. Given the uncertainty, M&A activity across the sector has also been relatively subdued year to date. While interest costs are expected to increase over the medium term, underlying fundamentals for most property sub-sectors remain strong, as does the current demand and pricing of real assets. However, we acknowledge that valuations tend to be backward looking so any potential expansion in cap rates may not flow through until 2023.

We remain focused on the niche sectors that are delivering good underlying cash flows underpinned by strong tenant covenants, growth opportunities and sustainable distributions. This includes REITs exposed to pubs, social infrastructure, convenience retail, as well as industrial/logistics. We expect the favourable tailwinds for industrial/logistics assets will remain in place with significant demand for the asset class given the growing shift to e-commerce and focus on supply-chain resilience.

Near-term unknowns and risks include movement in bond yields; the general economic environment/recovery coming out of COVID-19; impacts on leasing/rental markets, particularly for office; and increasing costs.



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For a full explanation of the recommendation structure, refer to our website at [morgans.com.au/research\\_disclaimer](https://morgans.com.au/research_disclaimer)

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

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**Craig Watson**  
Managing Director  
Morgans Port Macquarie  
AR: 000259176



**Ben Hollis**  
Branch Manager  
AR: 000252610



**Michael Sheridan**  
Financial Planner  
AR: 000438317



**Chris Young**  
Financial Planner  
AR: 000294648



**Richard Blomfield**  
Portfolio Analyst and  
Financial Planner  
AR: 001002547



**Gregory Harris**  
Financial Planner  
AR: 000419850



**Suzie Barnaby**  
Financial Planner  
AR: 001004887



**Sam Wicks**  
Financial Planner  
AR: 000431776



**Matt Buttsworth**  
Financial Planner  
AR: 001002173



**Matthew Butturini**  
Financial Planner  
AR: 001251241



**Michael Mears**  
Financial Planner  
AR: 001262470



**Porsha Papas**  
Financial Planner  
AR: 001270130



**Brendon Colville**  
Financial Planner  
AR: 001258961



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