CIO Monthly Note

February 2016

Be prepared for some surprises this reporting period

This week the equity market is bracing itself for the February reporting period. Reporting period is that time of year when companies confess their sins and fund managers lie awake at night.

Like all reporting periods, this one is sure to bring some big surprises and share price volatility.

This reporting period is occurring in an environment of increased economic uncertainty and market volatility. Global equity markets endured a terrible start to the year in 2016 with almost every index down in the month of January. The main causes of this volatility have been concerns around China, a collapsing oil price and weakening US economic data.

Going into a reporting period with this economic backdrop, our strategy is to be defensive with an underweight to resources. With annual falls of over 30% in the oil and iron ore price, it is not hard to see why resource companies will generally be downgrading their earnings this reporting period.

Outside of the resource stocks, the other high risk category going into this reporting period is those expensive high-growth stocks that are priced for perfection.

While broader PE multiples across the market are around historical averages, the relative valuation of 'high growth' stocks is sitting near 15-year highs. Any revenue or earnings misses from these companies are likely to be met with a punishing de-rating from the market.

When examining the earnings environment of companies exposed to the domestic economy, it is worth being more nuanced in our assessment.

Following the RBA's rate cuts and the depreciation of the Aussie dollar, the domestic economy has begun to slowly rebalance away from mining and towards services and other east coast dominated sectors.

This has seen a pickup in housing, retailing, tourism and some trade exposed industries. Therefore, it would not be surprising to see some positive earnings surprises in select industrial sectors of the market.

Putting the resources and industrial earnings environment together, our expectations for overall market earnings growth in FY16 remain subdued.

In a low growth and low interest rate environment, it will be hard for corporate Australia to achieve top-line revenue growth. This is especially relevant for the large cap stocks which generally operate in more mature markets.

Outside the top 30, the earnings picture is somewhat better with companies able to grow earnings independent of the broader economy.

When investing in stocks outside of the top 30, we prefer companies that have solid business models, strong balance sheets and those that can offer an attractive and sustainable dividend yield.

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