CIO MONTHLY NOTE

September 2016

The wash-up from reporting season and the market outlook

With the August reporting season complete we finally get to review the report card on the health of corporate profits in Australia. It is a good time to pause and consider the outlook for the market over the next 12 months.

Expectations were subdued as reporting season opened, a view point that was swiftly validated. There was little for the market to get excited about unless you had exposure to the mid, small and microcap sectors. There was a silver lining as the smaller companies index significantly out-performed the larger cap sector by nearly 14% for the financial year 2016.

Overall, earnings growth estimates for the 2016 financial year were revised down from an already weak -6.7% to an even more negative -8.0%. This poor result was driven by a near halving in earnings for resource companies and a 2.0% decline for the banks. It was also the second consecutive fiscal year of negative earnings - a rare event. This is partly why interest rates have been heading lower as operating conditions have been difficult for corporate Australia. Falling profits are also not good for Canberra, as Government coffers receive less tax receipts.

The outlook for the recent fiscal year would have been even worse if there was not the recovery in some bulk commodity prices (iron ore and coking coal) and energy. Unfortunately the estimates for earnings growth in 2017 were cut from around +7.0% to +6.0% after reporting season.

Equity analysts are an overly optimistic bunch, but I think it's premature to get too excited at the prospect of a big earnings recovery in 2017. Why?

Firstly, management commentary during reporting season was generally subdued, with very few larger firms expecting improvements in trading conditions over the year ahead. Conditions are still deteriorating in the resource states and most economists expect a cooling in the property market in NSW and Victoria over the year ahead.

Secondly, a turnaround of earnings growth from -7.5% to +6.0% would represent a very sharp bounce. The lack of obvious economic tailwinds make it hard to see a market-wide earnings uplift in the year ahead. However a falling Aussie dollar and lower cash rates would help drive a strong earnings recovery and help the market earnings recover.

Thirdly, while resource company earnings should improve following the stabilisation in key commodity prices, a large cyclical recovery in commodity prices would require a large and sustainable pickup in China – unlikely however given China is facing some significant structural challenges including rebalancing and deleveraging.

Without any strong drivers of top-line revenue growth, we will need a sustainable pick up in earnings growth to see an improvement in the economic outlook.

Rather than looking for a large cyclical recovery, we remain defensively positioned and are instead looking for specific idiosyncratic opportunities including the Chinese consumer, tourism and specific commodities exposed to growing industries. We also continue to prefer exposure to the mid, small and microcap sectors of the market. These companies will be more nimble in the current environment and offer investors some unique growth opportunities in the year ahead.

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