CIO MONTHLY NOTE

August 2017

Reporting season update – earnings bounce has been delivered

The semi-annual report card for corporate Australia - the August Reporting Season - is now in the final week. In general, earnings recovered strongly over the past year. However, there was a case of minor profit downgrades in contrast to very robust expectations, along with a slowing dividend growth outlook. While the momentum of earnings upside is slowing, the ASX300 30 June 2018 target of 6,250 and December 2018 target of 6,500 is still on track.

The positive is that the long overdue earnings rebound for the fiscal year (FY) ending 30 June 2017 has been delivered. Earnings per share (EPS) for the broader market will be just under 18% for FY17 compared with the previous year. This is a very strong outcome. This looked to be as high as 18.5% heading into the current reporting period, however some minor downgrades have been a feature this month.

While there have been downgrades against expectation this reporting period – around 0.6% to date – it is not unreasonable compared to the average downgrades heading into recent reporting period. Further, the overwhelming message is that there has been a 17.5% bounce in earnings for corporate Australia following two previous fiscal years of earnings contraction.

Ultimately, equity valuations are all about future earnings and expectations. The Price/Earnings (PE) multiple of 15.4 x 1-year forward is not unreasonable. While valuations are not expensive, there is some caution with the lack of solid guidance being delivered by Australian CEOs and their management teams. There appears to be some divergence between robust business survey data and the underwhelming forward guidance from corporate Australia. This is illustrated with consensus earnings (EPS) guidance for the current fiscal year (FY18) around 2.0%. This looks too low. The combination of a lower AUD and current accommodative interest rate settings continuing implies upgrades to FY18 earnings and beyond.

Another feature has been the slow down on dividend growth. Given they were already at very lofty payout ratio levels we don't see this as cause for alarm. Dividends will continue to be a key contributor to your total return. Bear in mind that the second half of the year tends to deliver more dividends compared to the first half. Also, dividends are generally delivered in a very uneven manner over the year. Thus, we expect a sizable dividend dump between now and year-end. For example, the last week in August will see around $2.6 billion of dividends coming from the listed REIT sector alone.

The resource sector has been the key stand out contributor to the earnings surge over the past year. Resources have also delivered some very reasonable dividends as a combination of stronger than anticipated commodity prices, controlled CAPEX and capital management having delivered cash back to shareholders. While this is set to continue, the resources sector should not be relied on to deliver consistent dividends over a business cycle. However, the resources sector profits look healthy for now and they will continue to distribute some cash back to shareholders.

Telstra was a standout major disappointment this reporting period, starting with its sizable dividend cut. We have cautioned on a dividend cut in the current fiscal year given the very high and unsustainable payout ratio. The dividend cut was delivered a little earlier than the market anticipated, hence the big drop in their share price.

Outside the resources sector the big four banks have been reasonable performers, however they will continue to struggle to maintain their margins and return on equity (ROE) targets in the years ahead unless they continue to review their non-core banking business units. Going forward they will continue to offer a very reasonable dividend but will face challenges to their margins. I would expect to see the major banks continue to exit non-core business units that have a higher cost to income ratio and higher regulatory capital requirements.

Looking at the report card the weaker than expected performers were Telcos (Telstra, Vocus), Healthcare (Ansell, Resmed, Healthscope), Insurance (QBE, IAG, Suncorp) as well as Domino's Pizza, Crown, SEEK and James Hardie. The upside to some of the non-AUD earnings is the expectation of a recovery in earnings if the AUD heads lower.

The better than expected surprises came from the Regional Banks (Bendigo & Adelaide Bank, Bank of Queensland), Diversified Financials (ASX, IOOF, Janus Henderson, Perpetual), various industrials (Amcor, Orora) as well many different key resource sector contributors.

In summary, the report card for corporate Australia remains reasonable, underscored by the earnings surge over the past year. Some key factors are required to get earnings upgrades in the year ahead. They include a lower AUD, the RBA maintaining low interest rates and some improved confidence and guidance from CEOs. There is always a silver lining. An ASX300 target of 6,500 by December 2018 is very much on target. In the meantime, prepare for some favourable dividends to drop between now and year-end.

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