

Profit reporting season wrap up & the Australian economy

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Key points

- The Australian December half-yearly profit reporting season was better than expected, though it did reinforce the picture of a three-speed patchy economy. A similar picture was provided by December quarter gross domestic product (GDP) data which came in better than expected, with growth of 0.7% in the quarter (2.7% over the last year) but with very soft private demand growth of just 1.6% last year.
- Expect solid economic growth from the June quarter to drive profit growth of around 15% over the year ahead, led by the mining and banking sectors with industrials (excluding banks) returning to high single-digit growth.

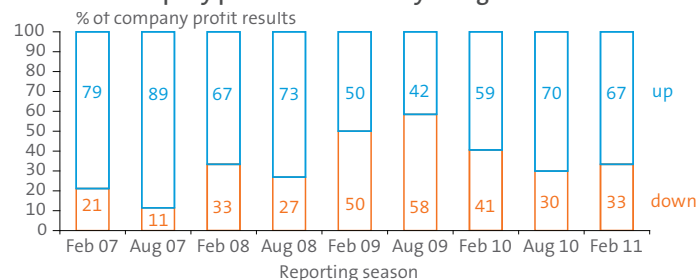
Introduction

Given the softness in the Australian economy outside the mining sector, there was a lot of uncertainty going into the recent earnings reporting season. In the event it wasn't as bad as feared. This is fairly similar to the picture provided by December quarter GDP data. A month or so ago there was concern that it might be negative, but it has come in at 0.7% quarter on quarter or 2.7% year on year. However both the earnings reports and the GDP figures disguise a very diverse picture beneath the surface.

Reporting season wrap up

The good news is that the December half-yearly profit results have been better than feared and there were no major blow ups. This is reflected in share price reactions that were split evenly between companies seeing their share price outperform the market on the day their results were released versus those whose share prices underperformed. This is reinforced by the fact that the market was able to rise 1.6% through February, despite global oil supply concerns at the end of the month. Most importantly, profit momentum is still up with 67% of companies having reported a rise in profits on a year ago.

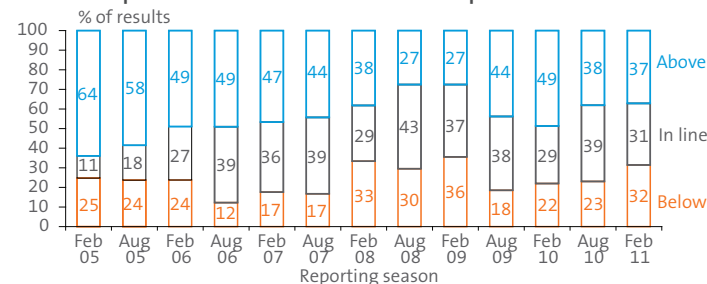
Australian company profits relative to a year ago



Source: AMP Capital Investors

Only 37% of companies have beaten expectations, which is down slightly on the August reporting season last year and well below the norm over the last seven years of 46%. The proportion reporting a negative surprise rose to 32%, the highest in two years.

Australian profit results relative to market expectations

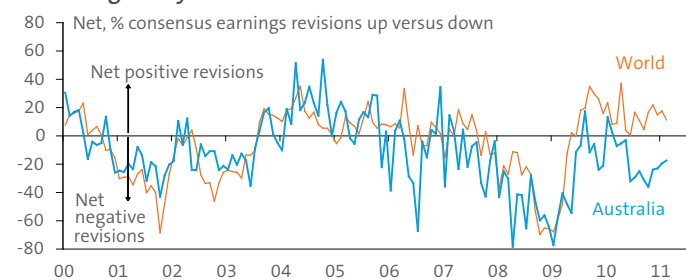


Source: AMP Capital Investors

Disappointingly, the ratio of positive to negative outlook statements has slipped from almost six to one in the February reporting season a year ago, to just 1.5 to one in the recent reporting season. Clearly the uncertainty over the domestic economic outlook has weighed on corporate confidence, particularly with real private final demand only up 1.6% over the year to the end of December.

Reflecting this, analyst revisions to earnings expectations have generally been negative in Australia. The next chart shows that the number of Australian companies seeing their earnings forecasts being revised down by analysts has continued to outweigh the number of companies seeing upgrades. This contrasts to the global picture where upgrades continue to dominate.

More downwards earnings revisions in Australia, but upwards revisions globally



Source: Thomson Financial, AMP Capital Investors

The downgrades are concentrated amongst steel makers, general insurers, telcos, diversified financials, contractors and discretionary retailers. Fortunately, on a capitalisation-weighted basis, consensus earnings expectations are little changed, reflecting strong results from resources and banks. Consensus expectations for earnings growth are 15% for this financial year and 14% for 2011-12.

Key themes

Several key themes are apparent. First, while aggregate profits are up 20% over the year to 31 December the results confirm the three-speed economy.

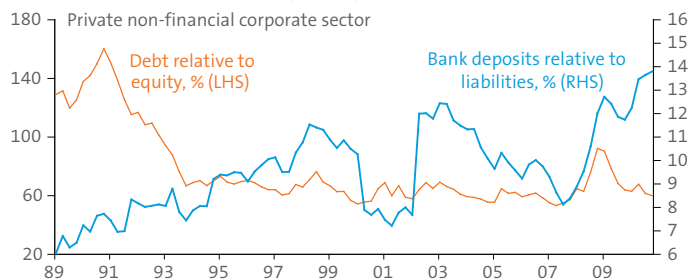
- Thanks to a huge surge in commodity prices which has boosted revenues even though overall mining production is subdued, resources companies have shot the lights out with 65% earnings growth over the year to 31 December. However, this was as expected.

- The big surprise was banks, with most surprising on the upside with December half results or trading updates. Bank profits are up nearly 25% over the year to 31 December on the back of modest revenue growth, but good cost control and interest margins having held up better than expected. As a result, bank results were mostly well received by the market.
- Industrials ex-banks have seen flat to slightly negative profit growth (or a small gain if Telstra is excluded). Telcos, diversified financials, discretionary retailers, gaming, utilities and health all saw falls in profits with general insurers flat, but gains elsewhere.

Interestingly, the market has been prepared to give the benefit of the doubt to companies adversely affected by poor macro economic conditions or the weather (e.g. Aristocrat, Brambles, David Jones and Leighton) but took a harder line against companies with fundamental problems.

Second, Australian companies are starting to return cash to shareholders via increased dividends or share buybacks. 77% of companies increased their dividends from levels a year ago. With corporate cash holdings at record levels and gearing low, there is plenty of scope for further increases in dividends and buybacks going forward, both of which are positive for the share market.

Australian corporate sector gearing is down, cash is up



Source: RBA, AMP Capital Investors

Finally, there is more evidence that cost pressures are starting to creep back in. 2008-09 saw widespread cost cutting in anticipation of bad times with talk of an approaching global depression. That didn't happen, but we are now starting to see cost pressures creep back in the form of higher raw material costs and a gradual pick up in wages growth. To be sure, wages are coming from a low base. But, unlike in America where jobs growth has been anaemic and so productivity has surged, solid jobs growth in Australia has seen poor productivity growth and more upward pressure on unit labour costs.

So where does this leave us?

Analysing the Australian economy and corporate sector has been made difficult by various cross currents including the floods, the huge boost to national income from the highest level for the terms of trade since the early 1950s and the ending of both monetary and fiscal stimulus.

One obvious problem is that for every statistical release on booming mining investment there are ten released on struggling household spending or housing-related activity, so any positive news is getting overwhelmed by news of softness. However, putting the economic impact of the floods aside, which is likely to temporarily take March quarter GDP growth into negative territory, the broader picture is still reasonable.

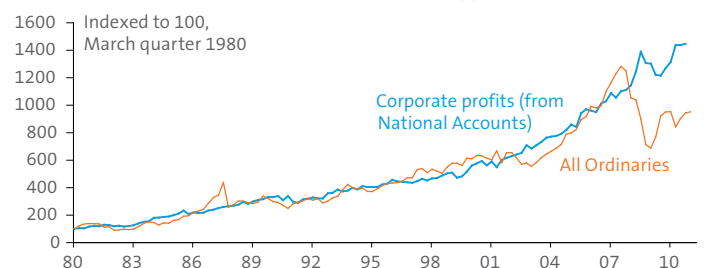
Firstly, the mining boom remains alive and well and, if anything, is strengthening with the terms of trade continuing to rise and set to further boost mining sector profits. The impact is feeding through the economy via higher wealth levels and dividend payments, higher employment, higher tax receipts and higher business investment. It is clearly evident in an 8.7% rise in net national disposable income over the last year. Mining investment, which accounts for 4% of Australian GDP, is set to add around 1.5 percentage points to Australian economic growth this financial year and 2.5 percentage points to growth for the 2011-12 financial year, if Australian Bureau of Statistics business investment intentions data are to be believed. This is likely to provide big benefits for mining services, building materials and transport companies.

Secondly, the banking sector appears to have come through a period of concerns about margins, low credit growth and worries about a housing price collapse reasonably well.

Thirdly, the range of considerations that have delayed the recovery in industrial ex-bank profits may now start to fade – the weather is unlikely to get much worse, post flood rebuilding will start to kick in, households have already built a big savings buffer so growth in consumer spending should be more in line with income growth, and the Reserve Bank of Australia is likely to be more measured in raising interest rates after a lengthy pause.

Overall this suggests an environment of reasonable – albeit still somewhat disparate – economic growth, consistent with around 15% profit growth over the next couple of years. The next chart illustrates that there is still plenty of scope for Australian shares to rise once current uncertainties start to abate, as they remain well below the level suggested by company profits.

Australian shares are well below the level suggested by profits



Source: Bloomberg, Thomson Financial, AMP Capital Investors

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