Shane Oliver, Head of Investment Strategy
& Chief Economist

Australian profits, the economy and shares

EDITION 27 – 4 SEPTEMBER 2013

Key points

> June half profit reports were poor consistent with sluggish June quarter GDP growth of 0.6% or 2.6% year on year.

> On a 12 month horizon however, a reduced cost base, low interest rates and a lower $A point to stronger economic growth and profits.

> The share market has moved up ahead of profits and while gains are likely to slow, they are likely to remain decent on a 12 month view as profits start to improve.

Introduction

Over the last year there has been much commentary warning of an impending collapse in the Australian economy. Much of this has come from foreign commentators sure that the mining boom is the only thing keeping Australia going. Consistent with this there was much fear going into the just concluded June half profit reporting season with many expecting another round of big earnings downgrades.

Although the profit results were not flash and growth is below trend, so far it has not been the disaster feared and there are reasons for optimism.

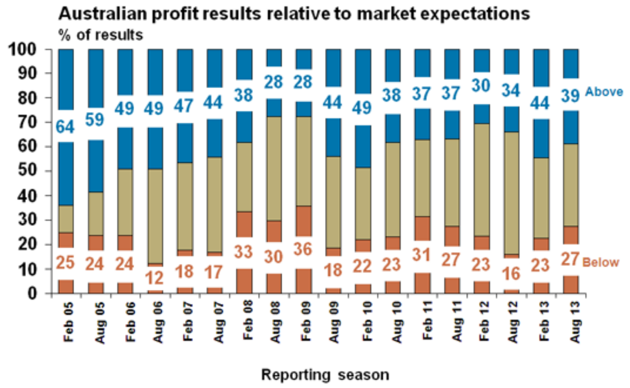
Profits not good, but not disastrous either

The June half profit results marked the second financial year in a row of falling profits for the market as a whole and the fourth year in five of falling profits. See the next chart.

Source: UBS, Deutsche Bank, AMP Capital

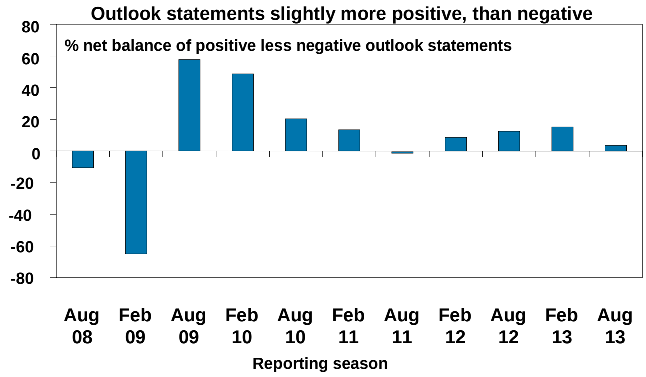
Prior to the reporting season the fear was that results would lead to more earnings downgrades. This hasn't happened.

- The first thing to note is that thanks to a steady stream of earnings downgrades from around March, consensus earnings expectations for 2012-13 had already been revised down from around 12% growth to around flat. In other words a lot of bad news had been factored in.
- Results were actually a little bit better than expected with 39% of companies exceeding analyst expectations, which is down on the December half results but better than seen over most of the last three years.



Source: AMP Capital

- 63% of companies have seen their profits rise from a year ago and 60% of companies have increased their dividends from a year ago as against only 12% which have cut them. As a result of increased dividends from resources stocks, dividends rose by a strong 10% last financial year. Strong dividend growth reflects both a degree of comfort with the profit outlook along with pressure from shareholders for increased dividends.
- While revenue growth was weak, cost control remains intense cushioning any further blow to profits.
- While corporate outlook comments have been subdued, the fact they haven't been too gloomy is a good sign.



Source: AMP Capital

- The lower $A provides a prospective boost to profits (equivalent to around 4.5% so far) and the higher iron ore price provides a boost for mining companies.

Consequently, and because the bad news had already been factored in we haven't seen the earnings downgrades some had feared. Earnings expectations for 2012-13 are little changed from where they were before results started to flow in late July at -0.5% (with resources earnings down around 21% but with earnings for the rest of the market up by around 6%). And for 2013-14 earnings growth expectations remain around 13%, made up of a 35% gain for resources and 8% growth for the rest of the market.

Reflecting the better than feared results and increasing dividends, 54% of companies saw their share price outperform the market on the day their results were released. Moreover the

Australian share market returned 2.5% in August despite global shares losing around 2%.

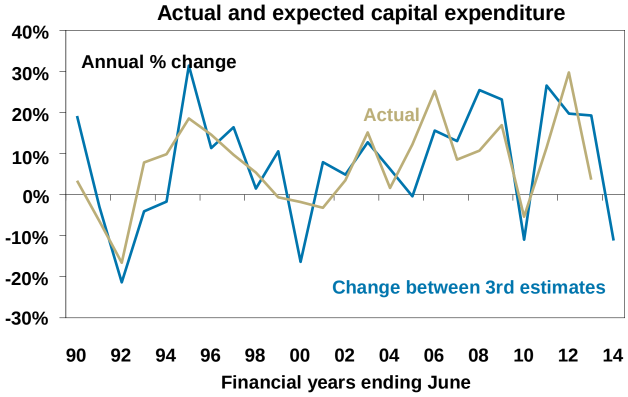
Cost cutting remains intense and will provide strong leverage for growth once revenue improves. The key going forward will be what happens to the economy.

Growth well below trend, but some hope

Since the June quarter 2012 Australian economic growth has been poor, averaging around a 2.5% annualised pace. June quarter growth this year was no different coming in at 0.6% or 2.4% annualised. This is well below the level necessary to absorb workforce entrants and hence unemployment has risen from 5% to 5.7%. The sub-par growth reflects weak consumer spending and a slowdown in business investment as mining investment has peaked.

The outlook for investment remains a big negative. A conventional interpretation of investment intentions from Australian businesses, by adjusting them for the average gap between actual and expected investment points to a 1% contraction in investment this financial year. However, an alternative approach based on comparing the latest estimate of investment for the current financial year to the corresponding estimate made a year earlier points to a deeper fall. See the next chart.

Actual and expected capital expenditure

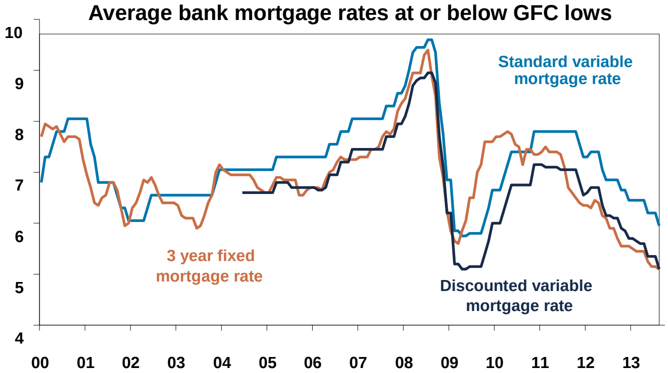


Source: ABS, AMP Capital

The initially tepid response to interest rate cuts reflects a combination of factors including post GFC caution, the initial tentative nature of rate cuts by the RBA, the failure of the $A to fall until recently, the limited pass through of rate cuts by banks, fiscal tightening and falling household wealth levels. However, while post GFC caution remains, some of these negatives are lifting. Specifically:

- interest rates have at last fallen to past cycle lows;

Average bank mortgage rates at or below GFC lows



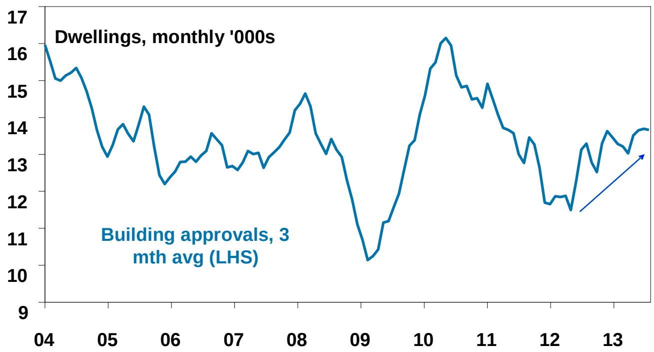
Source: RBA, AMP Capital

- the $A has fallen 15% from pre May average levels; and
- household wealth is up over the last year reflecting the rising share market and rising house prices.

Moreover, the normal play out from rate cuts to stronger growth seems to be gradually unfolding:

1. House prices have started to rise.
2. This is sending a signal to home builders to build more homes with building approvals rising which is likely to see rising housing construction levels.

Building approvals trending up



Source: Bloomberg, AMP Capital

3. Partly reflecting this consumer confidence is trending up.
4. At the same time, the lower $A should start to boost demand for local goods and services, whether it be cars, education and tourism.
5. Rising housing construction is likely to drive a pick up in retail sales.
6. This in turn is likely to help non-mining investment.

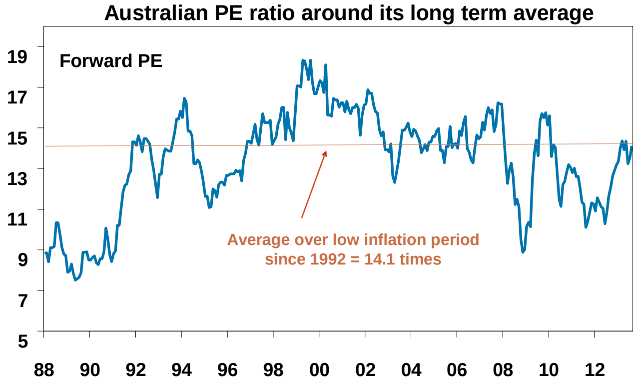
All of this will take time to unfold, but we do appear to have reached the third point mentioned above, which provides some grounds for confidence. To ensure that this process continues the $A needs to fall further (to around $US0.80) and to ensure this occurs the RBA will possibly need to cut the official cash rate a bit further (to around 2.25%).

Overall, while the next six months or so may still see sub-par growth around 2.5% as the economy transits from strong mining investment to more balanced growth, signs of an improvement are gradually appearing. This augurs reasonably well for a pick up in profit growth over the year.

Outlook for Australian shares

As has often been the case, the local share market has run ahead of profits, with all of the recent gains being driven by an increase in price to earnings multiples. However, the forward price to earnings multiple for Australian shares is still only around its long term average.

Australian PE ratio around its long term average



Source: Bloomberg, AMP Capital

Moreover, while there will be a few bumps along the way with a high risk of a short term correction, with earnings growth set to improve this should underpin further gains in the local share market over the year ahead. Our June 2014 target for the ASX 200 is 5500.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital