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AMP CAPITAL

Australian profits, growth, interest rates and shares

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Key points

- The December half profit reporting season was far better than feared and big cost controls have helped lay the ground work for stronger profit growth ahead.
- While interest rates may need to fall a bit further, green shoots of recovery suggest we are at or near the low and more importantly, point to an improvement in economic and profit growth on a 12-month horizon.
- While the share market has moved up ahead of profits this is not particularly unusual and price to earnings multiples are just around their long run average.

Introduction

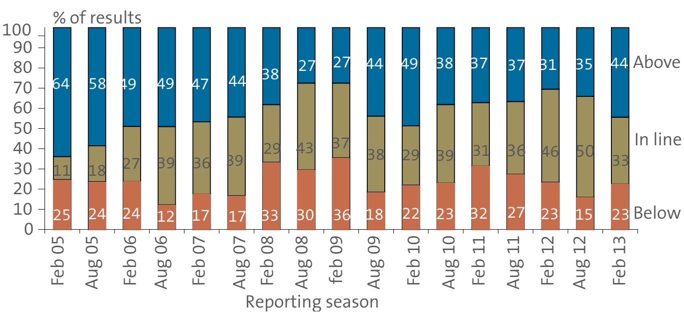
Since Euro-crisis lows in late 2011 the Australian share market has rallied 32%, reaching its highest level since the GFC. However, the share market has run well ahead of profits and there is still much debate as to how the economy will traverse the slowdown in mining investment and whether interest rates need to fall further. This note looks at the key issues, starting with the profit reporting season just passed.

Profits down but cycle looks to be bottoming

While the December half profit reporting season saw a fall in overall profits of around 9% on the December half a year ago, thanks to a roughly 35% slump in resources profits, the outcome was far better than feared and there's some light at the end of the tunnel. The key themes were as follows:

- First, results were much better than feared, with 44% of companies exceeding market expectations, which is the best in three years. Consistent with this, 55% of companies saw their share price outperform the market on the day their results were released, highlighted by good jumps in cyclical value stocks like Harvey Norman, JB HiFi, Qantas and Bluescope Steel.

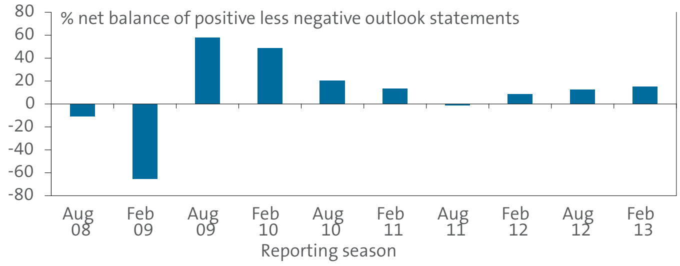
Australian profit results relative to market expectations



Source: AMP Capital

- Sales growth was weak at around 1%, but there was an aggressive focus on cost control and productivity gains to manage margins, which is a normal precursor to a decent rebound in profits and a sign that Australian companies may be starting to catch up with their American counterparts in focussing more on productivity.
- Outlook comments appear to be improving, with a rising trend in the net balance of positive relative to negative outlook statements as evident in the next chart.

Outlook statements more positive

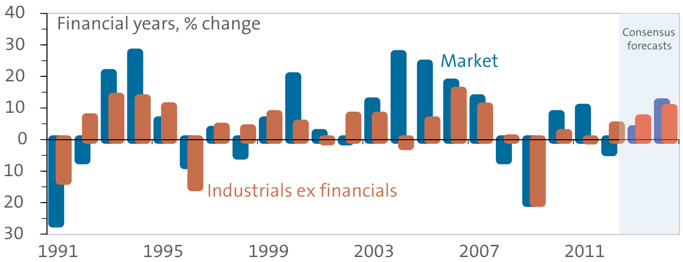


Source: AMP Capital

- The improvement in the outlook is backed up by rising dividends - 53% of companies increased their dividends from a year ago and only 22% have cut them. And 40% exceeded expectations on dividends with only 26% disappointing the market. Rising dividends suggest companies are confident that there will be an upturn in the profit cycle.

Reflecting this, analyst earnings estimates have been upgraded slightly for the first time in two years. Resource profits should bounce back a bit this year, reflecting in particular a rebound in iron ore prices after last year's fall. Profits for industrials (ex banks) bottomed in 2011 and grew around 12% over the year to the December half, helped by cost controls and a modest pick up in revenue.

Australian share market EPS growth



Source: UBS, Deutsche Bank, AMP Capital

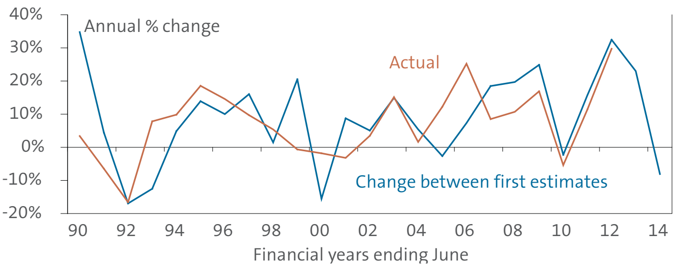
The key going forward will be what happens to the economy.

Growth still a risk but some positive signs are emerging

Australian GDP growth clearly slowed through the course of last year. In fact, growth has been stuck around an annualised 2.5% pace for the last three quarters as the pace of investment has slowed and consumer spending softened.

First the negatives. The biggest uncertainty relates to the slowdown in mining investment at a time of weak non-mining investment. On this front, the recent capital expenditure survey from the ABS presents a confusing outlook. A conventional interpretation of initial investment intentions from Australian businesses for the next financial year, by adjusting them for the average gap between actual and expected investment (the "realisation ratio"), points to solid investment growth of around 14% in total. However, realisation ratios vary dramatically from year to year and can be very weak in times of uncertainty. A contrary interpretation can be obtained by comparing the initial estimate of investment for the next financial year to the corresponding estimate a year earlier, and it fell for the first time in four years. This is only the sixth time in the last 25 years that this has occurred. When it has occurred in the past it often coincided with a fall in actual investment (see the chart below). At the very least, it suggests a sharp slowing in business investment growth.

Actual and expected capital expenditure



Source: ABS, AMP Capital

More broadly, the response to interest rate cuts has been sub par, with most economic indicators taking longer to pick up than has been the case through past easing cycles. This reflects a combination of factors including post-GFC caution, the failure of the A$ to fall, the limited pass through of rate cuts by banks, fiscal tightening and a perverse dampening effect on non-mining sectors from the mining boom, many of which were told repeatedly that they just had to adjust.

However, green shoots are gradually starting to appear, suggesting rate cuts are getting traction.

- Consumer and business confidence readings are up from their lows. Consumer confidence is in fact now at around the average level it has reached this far into the past three rate cutting cycles. The reason rate cuts help household spending is simple. Firstly, total household debt at A$1.7 trillion far exceeds the value of deposits at A$0.75 trillion. So the benefit of rate cuts to borrowers far outweighs the loss to depositors. Secondly, the spending of depositors such as self funded retirees tends to be far less sensitive to changes in their disposable cash flows than borrowers, particularly young families.
- Reflecting this, retail sales had a good start to the year.
- Home sales, auction clearance rates, house prices and to a lesser degree, housing finance, suggest that a gradual housing recovery is getting underway which should boost housing construction activity.
- Investors are starting to look beyond falling term deposits at higher yielding investments such as corporate debt and shares which is part of the process by which monetary easing forces more risk taking and spreads the availability of capital throughout the economy.
- The A$, whilst still strong, is at least off its highs.

To ensure that these still fragile green shoots flourish, there is a case for the RBA to cut rates a bit more to push borrowing costs down to the lows seen at the end of past easing cycles in 2002 and in 2009. For example, the major banks' standard variable mortgage rates are still around 6.4% compared to past lows of around 6%. However, this could be achieved if the recent improvement in bank funding conditions motivates the banks to cut mortgage rates independently.

However, 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 in turn augurs reasonably well for a pick-up in profit growth over the year ahead as profit growth for industrials remains around 10%, banks and wealth managers pick up on a slight improvement in credit growth and increased investor activity and resources sector profits return to modest positive growth.

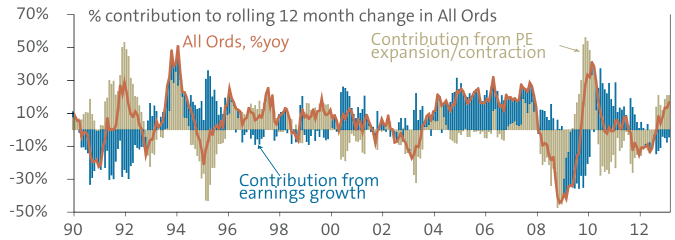
The other point of course, is that while there may still be one or two more rate cuts in the short term, we are nearing the end of the interest rate easing cycle.

Outlook for Australian shares

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. But as can be seen in the next chart, this is not uncommon as the share market often moves ahead of a pick-up in earnings.

Decomposition of changes in Australian share prices

Source; Bloomberg, AMP Capital



However, the forward price to earnings multiple for Australian shares has only increased to around its long term average. Moreover, while there will be a few bumps along the way with a high risk of a short term correction, earnings growth is set to improve which should underpin further gains in the local share market over the year ahead. Our year-end target for the ASX 200 is 5250.

...but why isn't the Australian share market at a record high like the Dow?

The fact that the US Dow Jones index has made it to a record high with the S&P 500 close behind, has to be seen as a positive. The US is finally shaking off the malaise it has been in for 13 years, helped by a recovering housing sector, an energy boom, a manufacturing renaissance and strong productivity growth. But why is the Australian share market still 25% below its record 2007 high, despite having a much stronger economy? The slower recovery in Australian shares from the GFC is due to a combination of much higher interest rates, the strong A$ and worries about China. More fundamentally though, the US share market has been spinning its wheels since the tech boom peak in early 2000. Since then, the Dow Jones index is up just 22% and the S&P 500 is up just 1%, but Australian shares are up 55%. So over this longer period Australian shares have performed far better.

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