Shane Oliver, Head of Investment Strategy
& Chief Economist

The Australian share market and profits

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Key points

- The December half-year reporting season was lacklustre, with fairly flat profits.
- Profit growth is likely to pick-up in the coming year but still lag consensus expectations for double digit growth.
- Australian shares are likely to rise over the year ahead as valuations are attractive and global shares are likely to rise, although we expect Australian shares to remain a relative underperformer for a while yet.

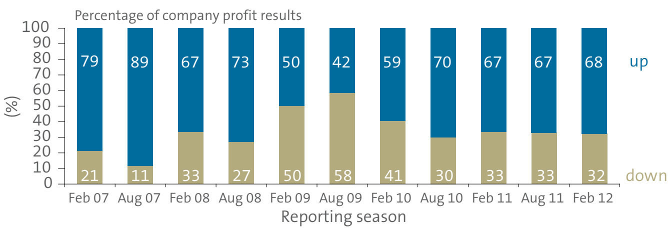
Introduction

There were plenty of nerves around leading into February with announcements of December 2011 half-year reporting in Australia. Domestic demand has been weak, the strong Australian dollar (A$) is bearing down on trade-exposed sectors and resource sector profits were coming off a high base with commodity prices falling in the second half of 2011. The results were pretty much as expected, in a word: lacklustre.

Reporting season wrap up

In good news, most companies saw profit growth over the last year, with 68% of companies reporting a profit increase.

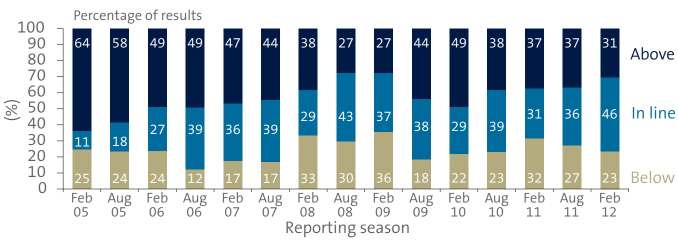
Australian company profits relative to a year ago



Source: AMP Capital

Against this, only 31% of results announced beat expectations, down from the 37% of companies that beat expectations for the June 2011 half-year results and well below the norm of 45%.

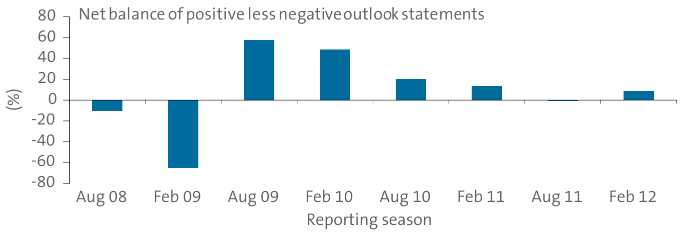
Australian profit results relative to market expectations



Source: AMP Capital

This is the worst earnings results since February 2009, during the global financial crisis (GFC). Reflecting this, results were greeted cautiously with 52% of company share prices underperforming the market on the day results were released. While outlook statements have improved slightly from the last reporting season, the net balance of positive statements remains relatively low.

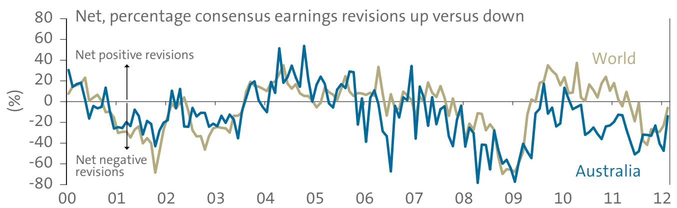
Outlook statements have become slightly more favourable



Source: AMP Capital

Reflecting the lacklustre reporting season, analyst revisions to earnings expectations have been generally negative. 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. Additionally, the pace of downgrades has been far more intense than the last couple of years, which partly explains the relative underperformance of Australian shares. However, the good news is that the pace of downwards revisions is slowing, as is the case globally. In fact, based on weekly trends, we believe global earnings revisions are likely to turn into net upgrades soon.

Downwards earnings revisions have been more intense in Australia, but have started to slow globally



Source: Thomson Financial, AMP Capital

The 2011/2012 financial year consensus earnings expectations have been revised down to 3%, from 7% in late January 2012 and from 14% a year ago. The downgrades have been concentrated to resource, insurance, media and other financials sectors.

Key themes

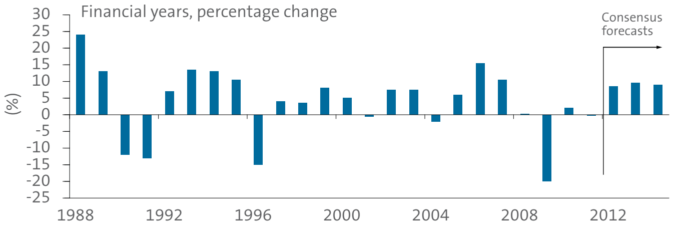
Several key themes have become apparent. Firstly, earnings growth was non-existent through 2011. Aggregate earnings have been effectively flat or slightly lower compared to the December 2010 half-year results.

Secondly, the weakness in earnings was broadly based across all major sectors with resource profits down slightly, non-bank industrials flat and banks slightly up. A similar message is apparent from the Australian Bureau of Statistics with their measure of profits up just 2.7% compared to a year ago which were up 20%.

Thirdly, the weakness in profits reflects a combination of factors with the main ones being weak domestic demand, the strong A$ and commodity price softness during the second half of last year.

Non-bank industrials have been hit by a combination of weak domestic demand, sticky cost bases which partly reflect the 2010 surge in workforces and the strong A$ bearing down on trade exposed sectors. Additionally, industrial sector profits have been doing it tough since before the GFC.

Non-banks industrials earnings per share growth



Source: Deutsche Bank

Banks have seen profit growth slow to a crawl on the back of soft credit growth, pressure on bank margins from higher funding costs and disappointing trading income.

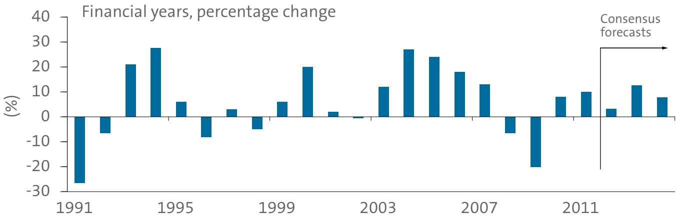
Resources have seen profits stall, partly reflecting the high base of 2010 but also a fall back in commodity prices during the second half of 2011 as well as increased costs associated with booming mining investments.

Of course there have been some pockets of strength, such as within mining services companies, which have benefitted from the surge in mining related investment as well as within health care stocks, among high quality franchises such as CSL, Cochlear and Resmed. The overall softness in profits is a confirmation of the broader weakness in much of the Australian economy.

Outlook

Consensus earnings expectations are for 12.6% earnings growth in 2012/2013 financial year.

Australian share market earnings per share growth



Source: UBS

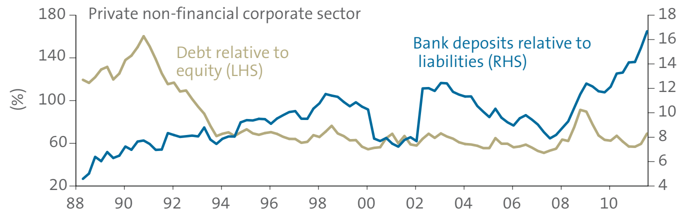
Profit growth is likely to pick up over the next financial year. The resources sector, in particular, is likely to benefit from an ongoing global recovery, modestly higher commodity prices and a rise in production. Industrials are likely to benefit from corporate restructuring, further falls in interest rates and an eventual pick-up in domestic demand, which should result in some margin expansion. Consensus expectations for margins are also more realistic than they were six to 12 months ago; however, profit growth is still unlikely to meet current consensus expectations for the 2012/2013 financial year. We estimate an outcome of around 7% growth more likely, attributed to the likelihood that domestic demand will remain constrained and the A$ will remain strong.

Where does this leave Australian shares?

A further downgrade in expected earnings growth is likely during the year ahead. The Australian share market is trading on a forward price to earnings (PE) ratio of 11.5 times. This is down substantially from 12.9 times a year ago. Even if the year ahead earnings expectations are downgraded by a further 5%, this would still leave room for circa 8% capital growth if the market were to rise to a forward PE ratio of 13 times. This level is below the market's 15 year average PE ratio of 14.5 times, but may be appropriate for the more volatile environment we are in.

Another positive is that with corporate cash holdings at record levels and low gearing, there is plenty of scope for further increases in dividends, buybacks and other corporate activity going forward.

Australian corporate sector gearing is benign and cash holdings are at record levels



Source: RBA, AMP Capital

Notwithstanding the risk of a short-term correction, further gains in global shares on the back of attractive valuations, continuing global recovery, easy monetary conditions and decreasing risk of a European melt-down are likely to help pull up the local share market over the coming year.

For the time being, the Australian share market is likely to remain a relative underperformer. Since late 2009, Australian shares have underperformed their global counterparts, thanks to a combination of tougher domestic monetary conditions which has constrained domestic demand and limited the flow of funds into shares. Additionally, the strong A$ and worries about a hard landing in China have adversely impacted markets.

Fears of a Chinese hard landing are likely to recede further. However, there is unlikely to be much relief in terms of the strong A$ (barring another GFC-like event, which would obviously be bad news) and monetary conditions in Australia are unlikely to ease much, relative to the US and Europe. This suggests that Australian shares could rise further this year, but continue to lag global shares for a while yet.

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

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