
# FINANCIAL *engineer*

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## Costs and competition

The Australian reporting season was disappointing, with significantly more misses than beats and a large number of downgrades to forecasts for FY19 and FY20. There was some offset from a number of special dividends, although dividend forecasts were cut in a range of sectors.

The results revealed pressure from rising costs and competitive pressures, and the slowdown in the Chinese economy. At a sector level, the weakness in the housing market was apparent from weakness in the property, materials and consumer sectors. Overall, we retain a neutral recommendation on the Australian market.

**Australian Equities Total Return %**

| To period ended February 2019 | Monthly | Quarterly | Annual |
|---|---|---|---|
| ASX 300 | 6.0 | 9.9 | 6.8 |
| ASX 300 Industrials | 5.8 | 7.0 | 3.9 |
| ASX 300 Resources | 6.9 | 22.2 | 19.1 |
| ASX 300 Financial Ex. A-REIT | 9.1 | 5.4 | -1.8 |
| ASX 300 A-REIT | 1.8 | 9.7 | 18.9 |

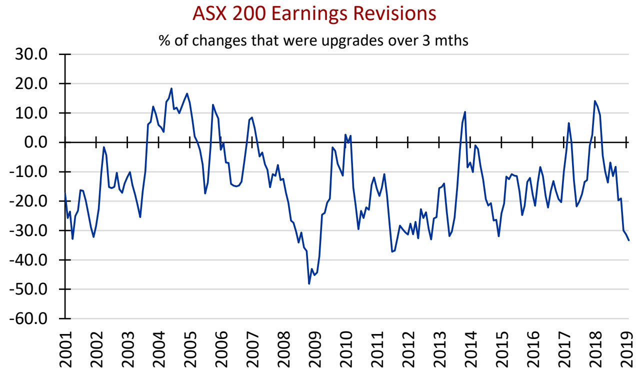
Source: IRESS Market Technology

# Costs and competition

During February, most Australian listed companies reported their results for the six months to December 2018. Perhaps not surprisingly, given recent macro weakness, the results were disappointing.

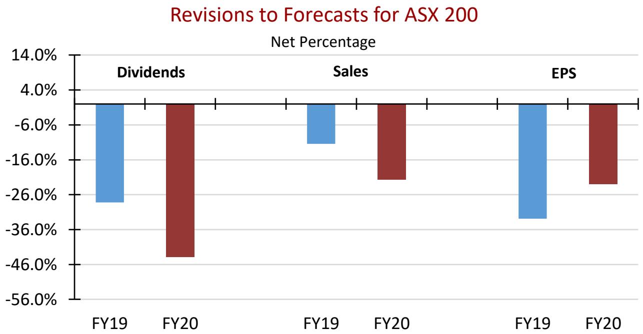
Using EAP analysts' estimates, there were 21 companies that missed, and 14 companies that beat forecasts. Disappointments dominated despite a number of companies having already downgraded guidance during the 'confession season' in November and December last year.

There was a corresponding decline in analysts' forecasts for the full 2019 financial year and for 2020. Using consensus estimates from Thomson Reuters Datastream, 2019 earnings per share (EPS) forecasts were revised down for 103 companies, and up for 52 companies — meaning net 33% of changes were downgrades. This pace of downgrades is the fastest since 2011.



Source: Thomson Reuters Datastream, Evans & Partners

The results were a little better for sales (net 11% downgrades), which suggests some margin pressure coming through rising costs and competitive pressures. Many companies have undertaken cost-cutting programs in recent years and these are coming to an end. It will be increasingly hard to grow earnings unless there is some improvement in the top line.



Source: Thomson Reuters Datastream, Evans & Partners

The pressure on margins was most apparent in some of the offshore operating companies (Resmed, Ansell, Cochlear and Brambles) and in the local building materials companies (particularly Adelaide Brighton and Boral).

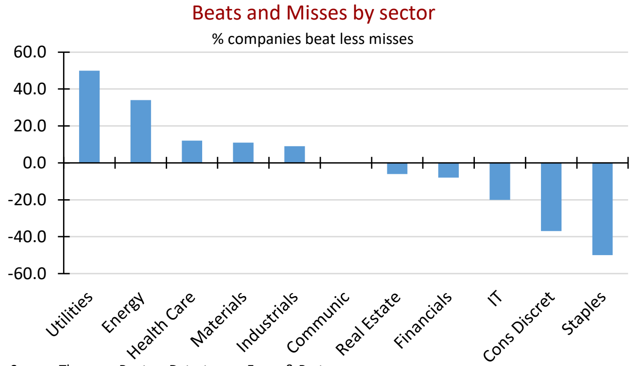
Weakness in the Chinese economy also shone through in a number of areas such as gaming (Star Entertainment and Crown) and in the consumer sector (Blackmores).

The news was also disappointing on dividends. Even though there were a number of companies that announced special dividends in anticipation of changes to franking credits (examples were Rio Tinto, Flight Centre, Fortescue, South32, Wesfarmers, Whitehaven and several listed investment companies), dividend forecasts were revised down for a large number of companies for both FY19 and FY20.

## Consumer and housing stocks the worst

It is also not surprising that much of the weakness in the reporting season was in housing, materials and consumer related sectors. By contrast, the best results were in utilities and energy.

The main disappointments at the stock level were in Stockland, Carsales, Woolworths, Coles, Unibail-Rodamco-Westfield, the Star Entertainment Group and Crown Resorts. The building materials sector also saw several misses including Boral, Adelaide Brighton, Bluescope and Fletcher Building.

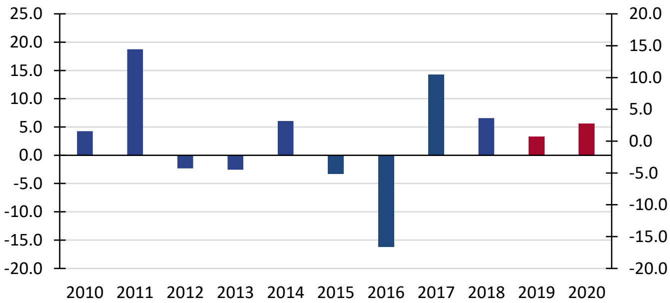


Source: Thomson Reuters Datastream, Evans & Partners

### Implications for the market outlook

The better news from the reporting season is that even though there were a large number of disappointments, their overall quantum was not large. As a result, full year 2019 forecasts only fell by 0.3%, and forecast earnings growth now stands at around 3.5%. Significant upgrades in iron ore companies have also provided an offset here.

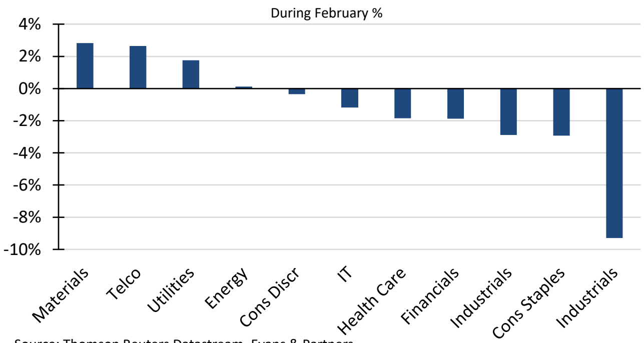
**Australia EPS Growth %**




*Source: Thomson Reuters Datastream, Evans & Partners*

For most sectors, FY19 forecasts have not changed by more than 3%. Note that the "materials" sector includes both resource stocks (where there were upgrades) and building materials (where there were downgrades).

**Changes to Australian FY2019 EPS forecast %**

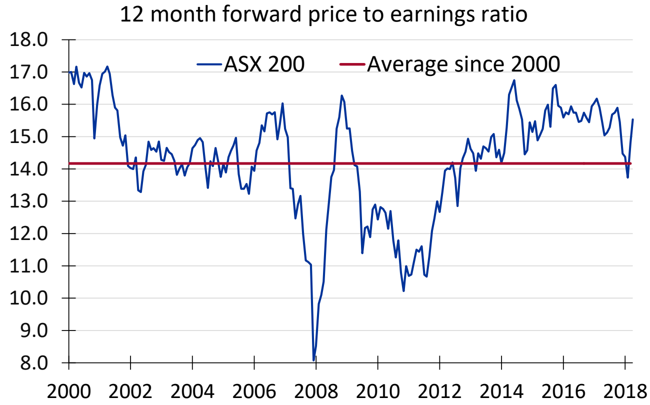



Source: Thomson Reuters Datastream, Evans & Partners

Despite these earnings disappointments, the ASX 200 rose strongly through the month. This has left valuations stretched, with the forward price to earnings ratio (PE) for the ASX 200 heading back above 15x.

**ASX 200 Valuations**

12 month forward price to earnings ratio




Source: Thomson Reuters Datastream, Evans & Partners

In our view, this level of valuations is at odds with the elevated risks around the Australian market and economy at present. There are two significant local risks in 2019 i.e. policy changes that may occur around the federal election (potentially to franking credits, capital gain tax, negative gearing and industrial relations), and macro risks from the pressures in the housing market. We retain a neutral recommendation for now and see better opportunities in offshore markets, particularly in Asia.

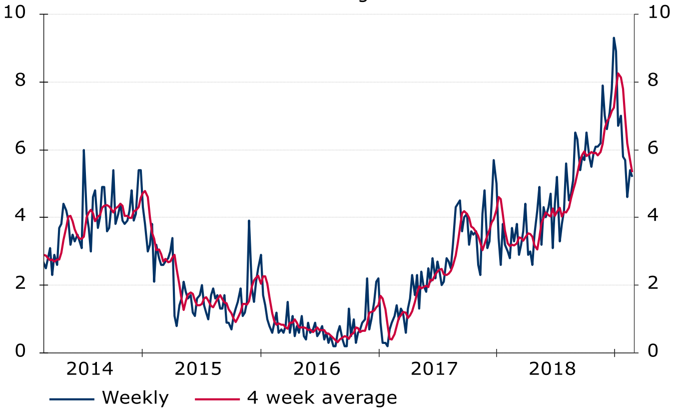
# The month that was

## Macro developments

Incoming economic data from China, Europe and Australia continue to be weak, while those for the US are holding up better than expected. Going forward, there will be much focus on whether easing political risk, stimulus in China and the end of policy tightening in the US will likely lead to a quick turn in economic momentum.

**US Weekly Retail Sales (Redbook)**

Year change %

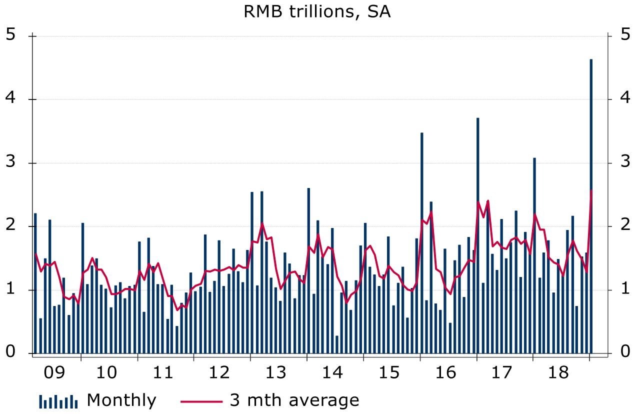



Source: Thomson Reuters Datastream, Evans & Partners

Concerns about a slowdown in the US appear to have been exaggerated, with recent GDP data showing a growth rate topping 3% for the final quarter of 2018. Manufacturing data is also holding up and there are early signs that the housing market is stabilising following the Federal Reserve's (Fed) pause and reductions in mortgage rates. One area to monitor is the consumer where there are mixed signals and high-frequency data points to a slowdown in recent weeks. The other critical issue is how long the Fed can pause given the steady acceleration in wages.

**China total social financing**

RMB trillions, SA

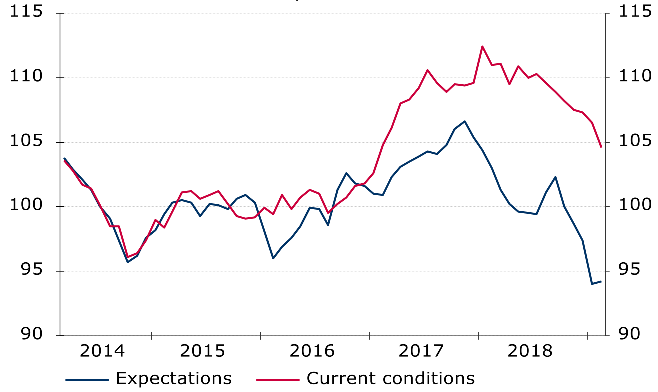



Source: Thomson Reuters Datastream, Evans & Partners

All focus in China has been on the January credit data that showed a significant acceleration in lending and suggested the end of the two-year deleveraging campaign. This would allow for an acceleration in investment and infrastructure spending over the course of 2019. Other recent data have shown weakness in a range of sectors, including manufacturing and consumption. In contrast the property sector is holding up very well and there are early signs that infrastructure spending is already stabilising.

**Germany IFO**

Index, 2005 = 100

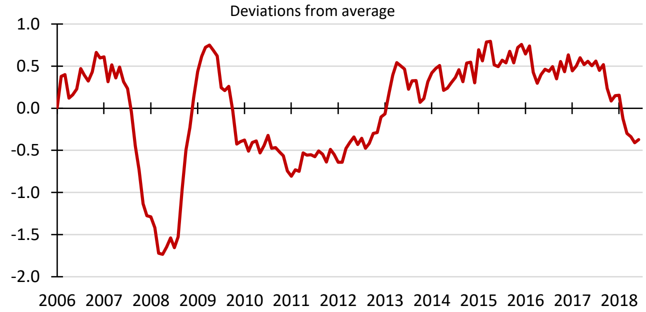



Source: Thomson Reuters Datastream, Evans & Partners

European economic news continues to be poor. The most significant deterioration has been in business confidence, which has not been assisted by a number of political concerns, including Brexit, protests in France and instability in Germany. At the sector level there appears to be a tussle between construction spending (which is generally strong, particularly in the north) and the export sector, particularly autos (which is suffering from tariff concerns, as well as regulatory changes).

Australian Recession Indicator

Deviations from average




Source: Thomson Reuters Datastream, Evans & Partners

It's a critical period in Australia as we monitor how the housing downturn is spilling over to the broader economy. Recent data shows that consumer and business confidence has weakened, but not by enough to indicate an imminent recession. The other critical data in the short term relates to the labour market (vacancies and employment intention) and auction clearance rates. Finance data will be particularly important to see whether banks will be more willing to lend following the release of the Royal Commission recommendations.

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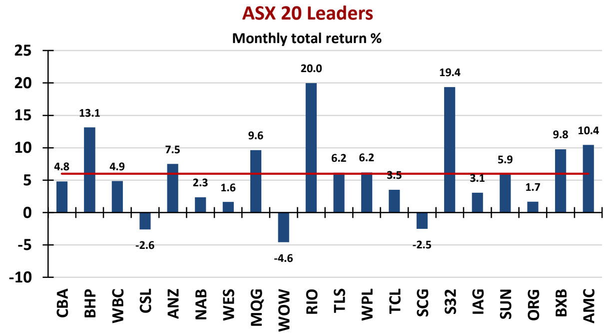
## Market developments

The minutes of the January Federal Open Market Committee meeting in the US confirmed the dovish shift in thinking by the Fed and expanded on its decision to maintain a large balance sheet and subsequently end the process of quantitative tightening by the end of the year. The commentary prompted a fall in long-term bond yields, which remain flat over the past two months — despite a spike in equity and oil prices.

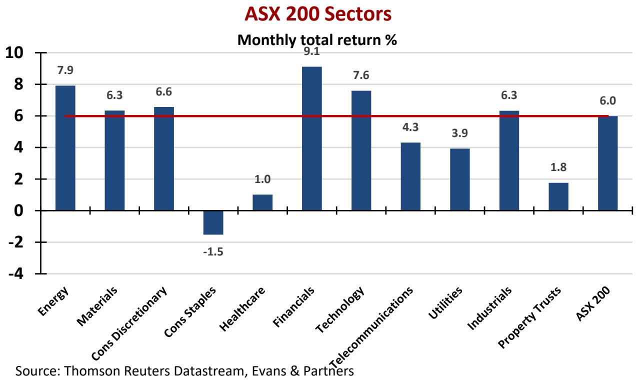



Source: Thomson Reuters Datastream, Evans & Partners

US earnings season was in full swing over the month, and overall, 96% of the companies in the S&P 500 have reported earnings to date for the fourth quarter. Of these companies, 69% have reported actual EPS above the mean EPS estimate, while 22% have reported actual EPS below the mean EPS estimate. The percentage of companies reporting EPS above the mean EPS estimate is below both the 1-year (77%) average and the 5-year (71%) average. At the sector level, the information technology (85%) sector has the highest percentage of companies reporting earnings above estimates, while the real estate (44%) sector has the lowest percentage of companies reporting earnings above estimates.

Looking ahead, analysts are predicting a 3.2% decline in first quarter earnings for FY19 and low single digit growth in earnings for the second (0.3%) and third (1.9%) quarters of 2019. The bottom-up target price for the S&P 500 is 3061.58, 10.0% above the last closing price. The energy (+16.0%) and communication services (+15.5%) sectors are forecasted to see the largest price increases, while utilities (+1.3%) and real estate (+3.8%) are expected to see the smallest price increases.

Investors cheered about a sudden change in sentiment in China as top policy makers endorsed a focus on growth by putting a pause on a crackdown in lending, and injecting liquidity into the economy. Optimism was further boosted following positive news flow relating to China's relationship with the US, a stabilisation in the yuan and the internationalisation process of the A-shares market.




Source: Thomson Reuters Datastream, Evans & Partners

Within Europe, the political landscape continues to hinder the appetite for risk assets. Brexit uncertainty continues to weigh on business sentiment as the March 29 deadline to leave the EU approaches. The UK services PMI fell to 50.1, with Brexit cited as the key reason for weaker demand. Interestingly, the market is becoming increasingly convinced that an extension of the Article 50 negotiation process will be reached, as opposed to a no-deal exit, causing sterling to climb 1.1% against the US dollar over the month. Meanwhile, according to the European Parliament's own internal forecasts, the "grand coalition" of centre-right and centre-left that has run the European parliament for 40 years is set to lose its majority for the first time following elections in May, as far-right and other right-wing Eurosceptic groups gain influence and slow the process of European integration.

| Investment Performance (Calendar Year Basis) | 2019 | 2018 | 2017 | 2016 | 2015 | 2014 | 2013 | 2012 | 2011 | 2010 | 2009 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Domestic** | | | | | | | | | | | |
| ASX 300 | 10.1% | -3.1% | 11.9% | 11.8% | 2.8% | 5.3% | 19.7% | 19.7% | -11.0% | 1.9% | 37.6% |
| ASX 300 Industrials | 8.5% | -4.3% | 9.2% | 7.4% | 8.3% | 11.0% | 26.7% | 28.0% | -3.8% | -2.6% | 34.1% |
| ASX 300 Resources | 16.6% | 2.3% | 25.7% | 42.9% | -24.9% | -16.6% | -1.4% | 0.1% | -25.0% | 12.3% | 46.7% |
| ASX 300 Financial Ex. A-REIT | 8.8% | -9.8% | 5.3% | 7.4% | 4.7% | 9.8% | 34.8% | 29.0% | -5.0% | -4.5% | 50.2% |
| ASX 300 A-REIT | 7.9% | 3.3% | 6.4% | 13.2% | 14.4% | 26.8% | 7.3% | 32.8% | -1.6% | -0.7% | 9.6% |
| Bonds (BBG Composite 0+ yrs Bond Index) | 1.6% | 4.5% | 3.7% | 2.9% | 2.6% | 9.8% | 2.0% | 7.7% | 11.4% | 6.0% | 1.7% |
| Cash (BBG Bank Bill Index) | 0.4% | 1.9% | 1.7% | 2.1% | 2.3% | 2.7% | 2.9% | 4.0% | 5.0% | 4.7% | 3.5% |
| **International** | | | | | | | | | | | |
| MSCI World Ex Aust - US$ | 10.8% | -9.4% | 24.1% | 7.8% | -2.2% | 4.4% | 23.4% | 15.9% | -7.2% | 12.6% | 33.5% |
| MSCI World Ex Aust - A$ | 9.9% | 0.5% | 14.6% | 8.9% | 9.6% | 14.1% | 43.6% | 14.5% | -7.4% | -1.2% | 4.8% |
| **Bonds** | | | | | | | | | | | |
| J.P. Morgan - US$ | 0.9% | -1.0% | 7.0% | 2.2% | -2.7% | 1.7% | -2.6% | 4.1% | 6.1% | 5.0% | 6.1% |
| J.P. Morgan - A$ | 0.1% | 9.8% | -1.1% | 3.2% | 9.0% | 11.2% | 13.2% | 2.8% | 5.9% | -7.8% | -16.7% |

Source: IRESS Market Technology

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