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A BETTER THAN EXPECTED EARNINGS SEASON, A BUMPY RIDE AHEAD

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Despite fears the recent reporting season would be a bloodbath, it's clear that two factors contributed to a better than expected outcome: the government's Job Keeper program subsidising costs and a change in consumption behaviours in some instances.

Notwithstanding this better than expected outcome, the outlook is negative for FY21. Declines are expected for defensive sectors and are likely to become more pronounced for cyclical stocks.

Most in the market are focusing on FY22 earnings per share (EPS) expectations as a better guide to earnings for companies. These expectations suggest that most listed cyclical companies will recover to pre-COVID levels by FY23. This may be optimistic.

Our major concern moving forward is that the government's fiscal stimulus is masking an underlying weak economy. While we definitely expect a bounce back in activity levels as restrictions lift, we're not convinced that pre-COVID levels are achievable.

Of significant concern is the impact this economic shock will have on small and medium size businesses (SMEs). In meetings with corporates over the reporting season, a number - including Telstra (ASX:TLS) and Insurance Australia Group (ASX:IAG) - discussed concerns with respect to impacts on SMEs.

Of the major sectors:

- **Banks** met expectations, helped by better funding costs, a deterioration in the number of delinquencies and strong capital buffers. However, banks are still to see the full impact of the credit cycle hit and a potential increase in delinquencies once the mortgage repayment holidays expire.
- **Iron ore** names were strong as expected, with balance sheets in good shape; however, the iron ore price is not sustainable.
- **Healthcare** companies all reported well; CSL guidance disappointed relative to consensus, however we don't see anything really compelling in the space.

- **Property trusts** – COVID has exposed structural issues in retail and although valuations have been cut, they are not yet compelling. The office sector is being affected by the perception that there's a structural shift in working from home; this is more likely to be cyclical and may present an opportunity in due course. Industrial property has been buoyed by demand for exposure to cap rate compression and continued growth.
- **Builders** – all reported weak results, as expected, with very uncertain outlooks. The upcoming infrastructure pipeline will help offset weak residential construction.
- **Staples** – Woolworths (ASX:WOW), Wesfarmers (ASX:WES), Coles Group (ASX:COL) and Metcash (ASX:MTS) all reported strong sales; although COVID costs meant margin expansion was limited, each still achieved growth. Increasing online penetration of sales is seen as an opportunity for WOW and WES to extend their dominance. WES believes Bunnings sales growth was a pull forward of demand, unlike peers in US Home Depot and Lowes who believe it's the new normal. There's likely to be a moderation in sales for all of these businesses as the economy opens up.
- **Insurers** Suncorp (ASX:SUN) and IAG have been hit by increasing natural peril allowances and re insurance costs; a key issue will be business interruption test case for IAG. QBE Insurance (ASX:QBE) seeing strong rates growth leading to its outperformance.
- **Tech/IT** – top line trends were strong for most.
- **Retailers** – as people stayed home and worked from home, electronic and homewares retailers such as JB Hi-Fi (ASX:JBH), Harvey Norman (ASX:HVN) and Kogan (ASX:KGN) experienced huge growth in online sales. We believe in most cases this will be a pull forward in demand, however even sales results into August were strong. Is this a structural shift? We think not. Apparel retailers did not fare well in comparison.
- **Other domestic cyclicals** – casinos and pubs were challenged, as operations were closed during lockdown. Crown Resorts (ASX:CWN) reopened Perth casino and has seen a strong rebound in trading. Tabcorp (ASX:TAH) traded well, with its lottery business exceeding market expectations, and wagering also doing well.
- **Telcos** – TLS delivered below expectations on the back of weaker profits from Mobile, lower roaming revenues and weakness in its enterprise division. In addition, the company downgraded its return on invested capital (ROIC) target to 7%. We think it's reasonable value at $2.90 with cost out to come, increases in mobile pricing and a rational industry outlook. ROIC for the industry is very low.
- **Utilities** – both AGL Energy (ASX:AGL) and Origin Energy (ASX:ORG) disappointed by lowering guidance on the back of expected weaker wholesale power prices, and weaker demand outlook for electricity.

Key risks ahead

The market rally has been particularly narrow in Australia, with healthcare, tech and iron ore names in the forefront. The emergence of retail investors in the stock market, including a cohort of first timers, has resulted in a bubble in particular sectors, with no attachment to fundamentals.

The shutdown in Victoria continues; the longer it's in place, the more specific sectors and companies will be affected. This includes portfolio exposures such as Crown (ASX:CWN), Event (ASX:EVT), Boral (ASX:BLD) and Premier (ASX:PMV).

Once the economy reopens nationally, a big question will be around the strength of the rebound. Many investors have a 'glass half full' perspective, which will be challenging for both the economy and markets.

Finally, the perception that interest rates are lower forever will be challenged because we see the potential re-emergence of inflation. Although it's unlikely in the shorter-term, given the excess capacity in economies globally, but it remains a substantial tail risk. The yield curve steepening in response to rising inflation could see a short sharp market correction.

Despite the better than expected earnings season, we're still to learn what 'COVID normal' will look like and how that might impact businesses, large and small. This is why sticking to an investment approach that's underpinned by a disciplined, active, value-based methodology is important, whatever the investment environment.

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