

Overview

Robust growth but outlook darkens

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Listed companies have delivered a year of double-digit earnings growth, thanks to record high commodity prices borne of the resources boom.

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But fund managers warn that despite an increase in dividends and cashed-up balance sheets, the outlook for industrial companies is very bleak and the Reserve Bank of Australia needs to cut interest rates sooner rather than later.

Analysts are also divided about valuation levels as rising input costs, the strong Australian dollar and margin pressures continue to crimp profit growth. At the same time companies are caught up in the global macro-economic problems of an ailing US economy and fears of a sovereign debt default in Europe.

The cautious outlook statements that followed many of the profit results this season also imply those companies not involved in the resources boom will continue to find business tough going, and investors should be ready for the market to fall further towards the recent intra day low of 3765.9. Yesterday the major S&P/ASX 200 Index closed at 4038 points, down 156 points.

"Earnings matter, and this season hasn't been that bad," Wilson Asset Management portfolio manager Chris Stott says, "but it has exacerbated the two-speed economy and, really, the market needs to see the RBA cut rates. I think we will get those cuts by the end of the year."

Stott says current earnings per share (EPS) forecasts for industrial stocks in 2012 are too high and in the weeks ahead will be downgraded.

Most analysts are forecasting EPS growth of 9 per cent for industrials for 2012, but Stott thinks this will be trimmed back to zero, despite the recent better than expected second-quarter national accounts number.

The latest data from the Australian Bureau of Statistics shows the economy growing at 1.2 per cent in the three months to June, bouncing back from the slump in the March quarter when floods and bad weather hit Queensland and Victoria.

But economists are quick to point out that during the past few months there has been a serious deterioration in the outlook for Europe and the US, as well as a drop in business and consumer confidence.

"The GDP report for the June quarter was 'hyped up' by the media but we expect the RBA to have been less than impressed," Westpac chief economist Bill Evans says.

Evans is calling for the RBA to cut rates 1 per cent over the next 12 months, warning the unemployment rate will rise to damaging levels if rates are not cut soon.

The August labour market report showed another fall in employment and a further rise in unemployment to 5.3 per cent.

A key theme this reporting season was companies planning to shed workers. Companies that helped employ more than 350,000 workers in the past year, thinking demand would take off and hiring labour would be a problem, are now folding under the pressure of slow demand and letting staff go.

They are learning to deal with a two-speed economy and the rising Australian dollar, which chopped \$3 billion from the profits of groups such as Macquarie Group, CSL and Westfield that earn a significant portion of profits offshore and made it harder for import-competing industries such as building materials.

In 2011, corporate Australia delivered annual EPS growth of about 14 per cent, in line with expectations ahead of the season, and according to most analysts will deliver earnings growth of 15 per cent again in 2012. But that number, too, is expected to be eased back over the months ahead.

"Clearly, global macroeconomic matters are going to dominate over the next few months," says Wilson Asset Management's Stott. "I am expecting a tough period for stocks, and we will definitely test the lows of 3750 again."

The good news for investors is the reporting season wasn't as bad as many had feared, and there were some bright spots. More than two-thirds of companies have seen profits rise on last year's result. And 37 per cent of results were better than expected, while just under one-third missed expected targets.

Given that many investors were fearing the worst in the lead-up to the profit reporting season, many stocks outperformed the market on the day of their profit announcements.

Analysts said the key themes from the season were soft sales growth, the negative impact of the rising Australian dollar, pressure to reduce costs – which means thousands of workers will lose their jobs – and increased buybacks and dividends. Profit growth for 2010-11 was around 11 per cent, in line with expectations, but that was due to the resources sector that contributed to more than a third. The banks provided some growth but for the rest of the market it was a hard slog.

Ausbil Dexia's chief executive, Paul Xiradis, says because expectations were low going into the season, earnings were not that far away from his initial thoughts.

"There were downgrades across the board and even resource stocks showed that costs were high. But there was a record number of buybacks and dividend payouts were good, so overall I feel far more comfortable owning the equities that I do," he says. "However markets are being held back by Europe's problems – but I think they are coming to a head and once they are sorted it will show the underlying fundamentals in our market are very good," Xiradis says.

The stars of the season, and companies that managed to surprise investors, included Seven West Media, Telstra, Commonwealth Bank of Australia, BHP Billiton and Rio Tinto. But a few shocking results from Billabong, Transfield Services, BlueScope Steel, QBE and Woolworths led to an overall fall of 2.9 per cent for stocks in the major index during August.

BHP Billiton's record \$US23.7 billion annual profit was the highlight of the season, underlining the powerful effect of commodity prices. Volumes were essentially flat, meaning price increases did the heavy lifting for BHP to eclipse its 2008 record result.

At the moment, BHP Billiton's 2012 price-earnings multiple (the price of the share divided by the earnings per share) is near historical lows at 8.9 – well below the market average of about 10 and the historical average of about 15.

The miner lifted its permanent dividend – a policy that commits it to at least maintaining its increased payout through the cycle – and is also committed to higher dividends and spending on growth projects.

BlueScope blamed the high Australian dollar for its decision to withdraw from the steel export business, with the loss of about 1000 jobs and about \$500 million in one-off costs.

The company reported a \$1.05 billion loss, driven by \$922 million of impairment charges, and was forced into making tough decisions after a combination of rising input costs, a higher dollar and low steel prices caused annual losses on exports of \$250 million.

The big question now for investors is China, and whether it can continue to provide enough demand for commodities. China's export growth is forecast to slow due to the renewed weakness in the US and European economies, but some experts say that despite efforts to curb it is well placed to weather any slowdown in global growth. CLSA Asia-Pacific's chief China macro-strategist, Andy Rothman, has told clients that the Chinese economy is in a better position to deal with any macro-economic issues than it was back in 2008. EPS for the resources sector in 2012 is tipped to grow by 23 per cent, with 9.5 per cent growth for the banks.

with Andrew White

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