Equity Trustees

Date: September 2024

KEY TAKEAWAYS FROM REPORTING SEASON IN AUSTRALIA AND THE US

Key summary points:

- Both the US and Australian reporting Seasons were solid relative to expectations.
- However FY25 earnings forecasts were downgraded given economic uncertainty.
- The ASX200 is trading expensive to historic levels, is forecast to deliver 3-4% earnings growth in FY25F and a slight reduction in dividends.
- US Equities are also trading expensive relative to historic levels but offers a stronger earnings growth outlook supported by the mega-tech names and a broadening into other sectors as interest rates fall.
- We remain tactically underweight equities given valuation and macro concerns.

Australian Reporting Season takeaways

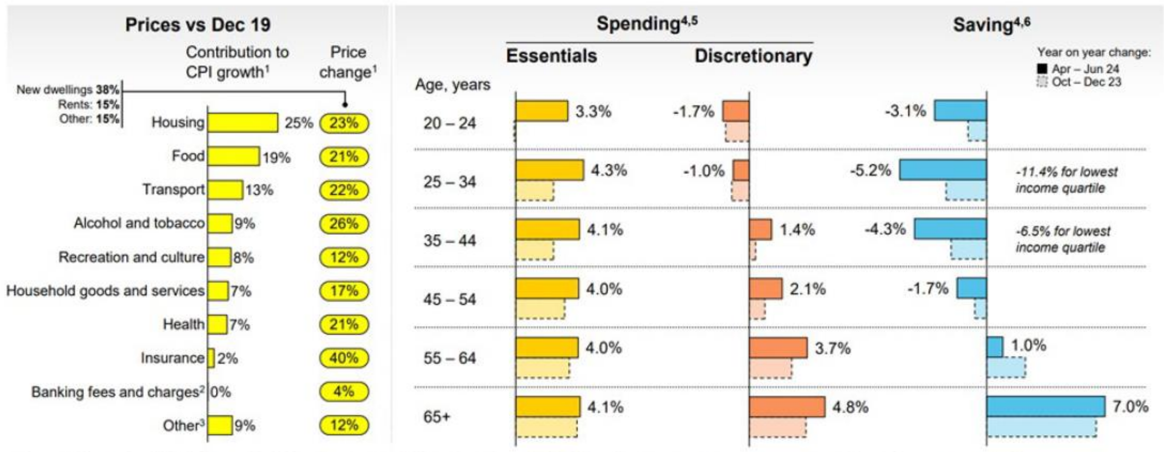
Australian reporting season was reasonable relative to expectations. In the end, FY24 earnings growth for the ASX200 was ~-4.5% (year-on-year) registering the second straight year of falling profits for the index, while dividends fell ~1.9% on FY23.

There were more earnings beats than misses with margins holding up better than expected.

- While this is positive, the percentage of beats were less than the prior two reporting periods as the economic cycle has progressively slowed.
- Large caps produced a stronger set of results relative to expectations than small companies.
- Corporates lifted payout ratios to produce dividend surprises which included special dividends.
- Technology and Retail fared better than expected, while Banks also produced a solid set of results. Energy results were worse than expected.
- While pricing power is not as strong as it was due to the softer demand environment, management teams have remained focused on cost cutting to protect margins.
- High interest rates and cost of living pressures are impacting, however inflationary pressures are becoming less onerous.

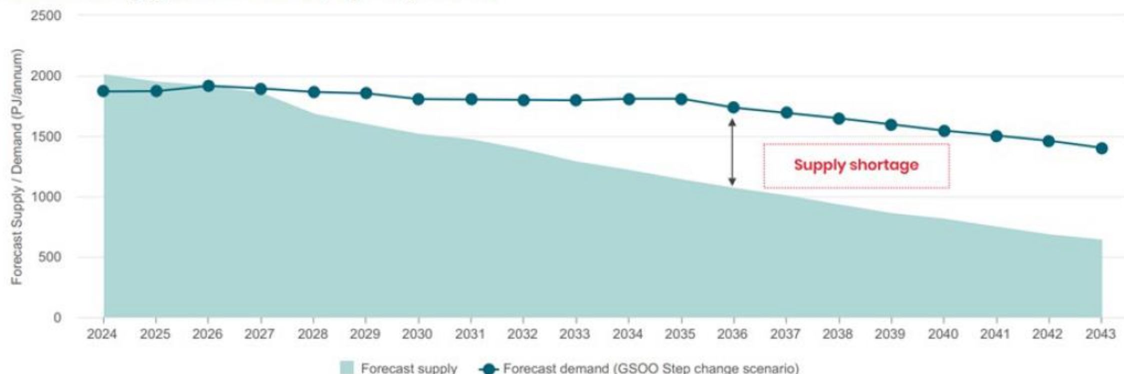
Key themes:

- Quality brands with strong market positions fared well. Companies such as Commonwealth Bank, JBHifi and Qantas demonstrated strong operational results.
- The consumer environment fared better than expected but the environment remains bifurcated with older Australians better positioned relative to younger demographics (as shown in the chart from Commonwealth Bank below). Cost-of-living pressures were cited by many companies as a major headwind. However, cost of living relief and income tax cuts should help in the near term although many believe that relief will be saved rather than spent.



Source: Company reports.

- While Bank asset quality remained strong, there were some signs of rising arrears. Overall listed corporate balance sheets remain relatively healthy.
- The housing construction cycle remains soft with higher interest rates, affordability, and construction costs as key headwinds. This reinforces the under-supply issues within the housing market. The infrastructure outlook remains solid.
- Digital and e-commerce trends were emphasised. The discussion of AI's positive practical applications is increasing.
- The Energy Transition journey is likely to take longer and is becoming harder. Gas remains an important element of the transition.



Source: Company reports.

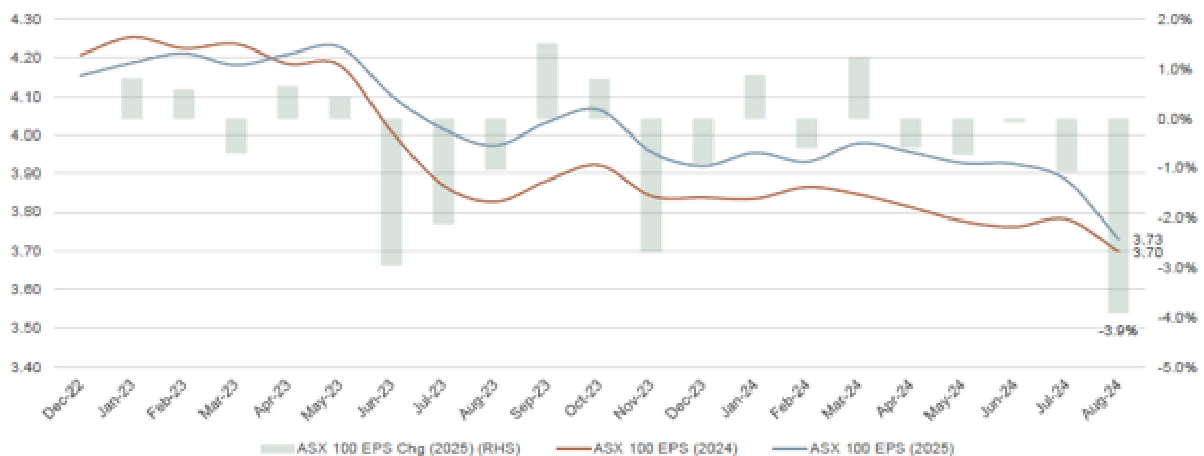
- While commentary remains mixed the office market might be close to finding a bottom. Premium, well located assets are seeing stronger demand while the medium-term supply outlook is softening due to rising costs.
- The Chinese economy remains weak. This is impacting on commodity prices. The economy may worsen further, especially if the US increases tariffs on Chinese goods.
- M&A levels remain relative subdued.
- Labour markets are clearly softening enabling easier access to staff. Increased labour costs are continuing to impact negatively on companies, especially those not able to pass on those increased costs eg. Private hospitals.

The outlook - Company guidance was cautious.

Despite reporting solid results, FY25 earnings were downgraded overall, as corporates remained cautious on the outlook. One-year forward EPS (Earnings-per-Share) for the market was downgraded by ~3-4% in August continuing the progressive negative earnings revisions that have occurred over the last year.

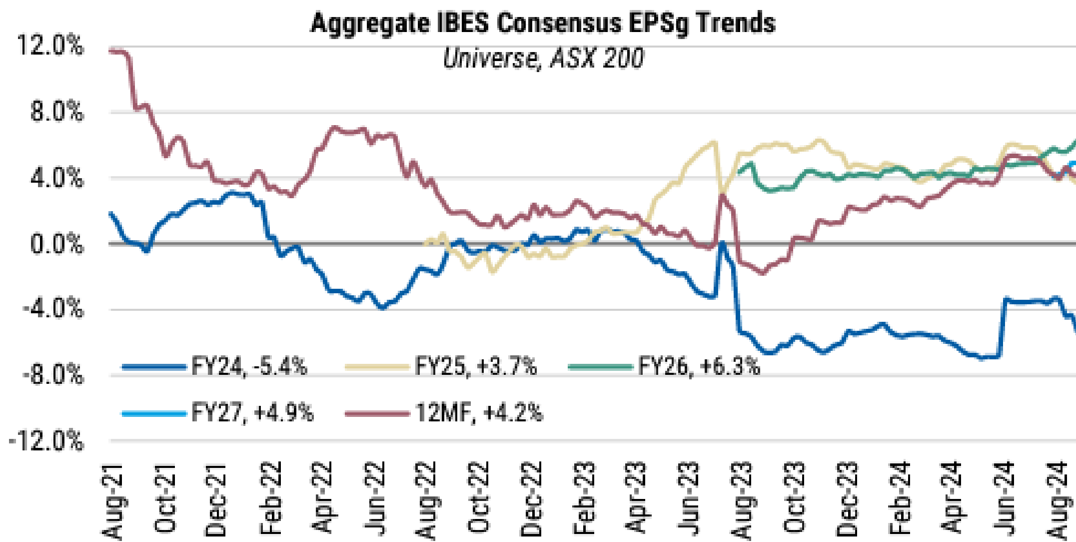
- Revenue growth is slowing. Margins were cut as top line pressures remain in place while cost pressures remain.
- Downgrades were broad-based; however Tech, Telecom and Financials (including Banks) were the rare sectors receiving earnings upgrades.
- Materials (Resources), Energy, Utilities and Media sectors experienced more material FY25 downgrades.

S&P/ASX 100 2024 and 2025 Earnings-Per-Share (EPS) outlook revision history



Source: Barrenjoey Research, FactSet

FY25 EPS growth is expected to grow by ~3.7% driven by Industrials and AREITs. Bank earnings are expected to marginally grow, while Resource company earnings have suffered from recent downgrades are now expected to fall in FY25F.



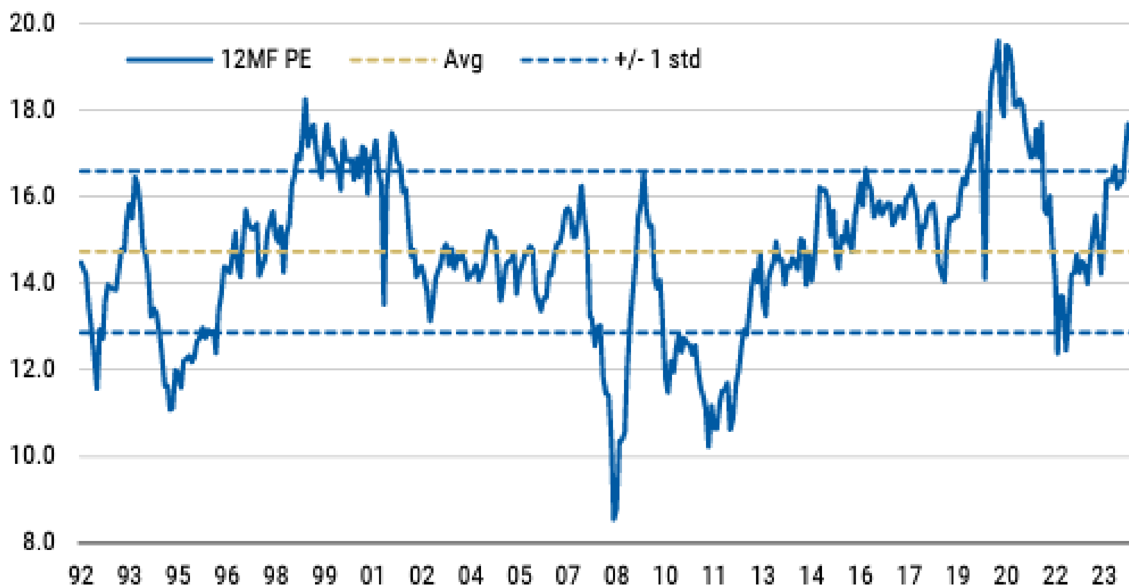
Source: RIMES, IBES, Morgan Stanley Research. Data as of August 29, 2024.

Implications for the ASX200 outlook

ASX200 price-earnings (PE) valuations expanded during August and are trading above 17x. Apart from Energy and Materials, sector forward PE multiples are trading at 12-month highs. For the PE multiple to reduce to long term average levels implies earnings upgrades of ~20% - which is very unlikely given the slowing economic backdrop locally and globally.

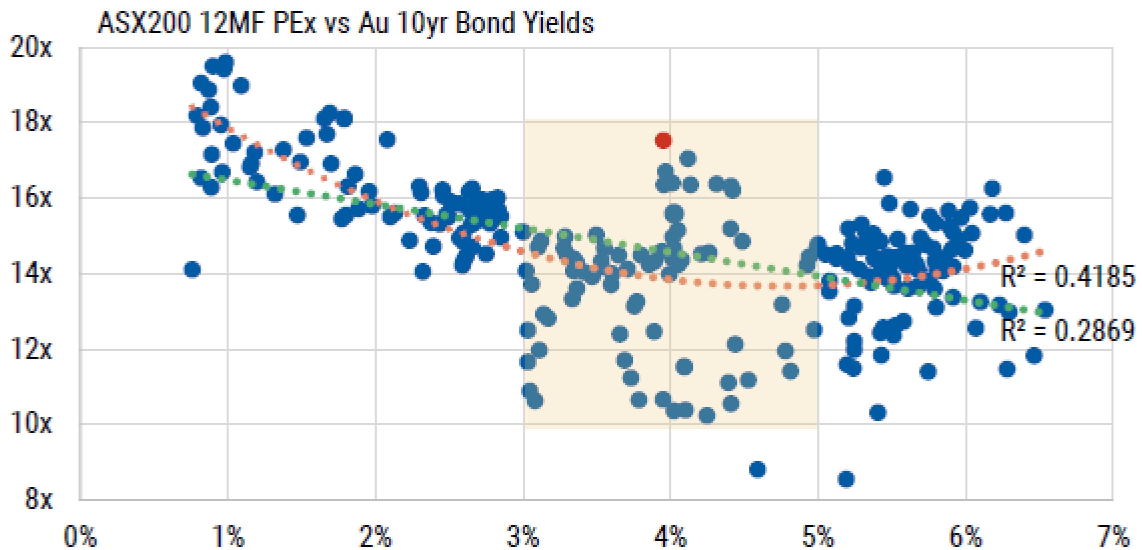
While there is an expectation for future interest rate cuts which could buoy economic growth and equity multiples, arguably this is currently priced in. Therefore, in this environment, we think selective quality exposures with reasonable valuations should outperform.

ASX200 Market Price-Earnings multiple is now > 17x above long term averages.



Source: RIMES, IBES, Morgan Stanley Research. Data as of September 05, 2024.

While the market may be starting to price in lower rates, based on historic PE levels relative to Australian 10-year bond yields, it appears that the market is already pricing in Australian 10-year bond yields of < 2%.



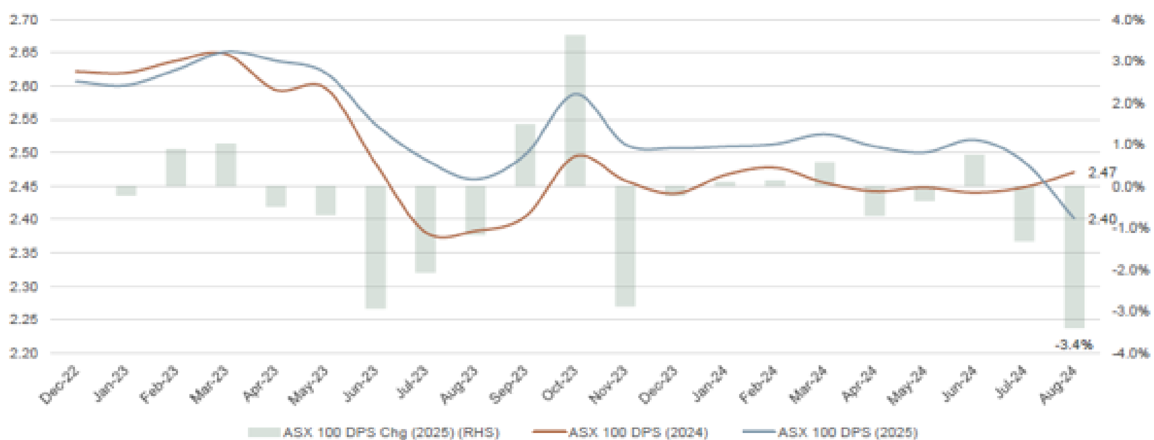
Source: RIMES, Factset. Morgan Stanley Research

Australian equities – Income outlook

There were more beats than misses in FY24 dividend announcements. Several companies announced special dividends and/or buybacks. The insurers were one sector that has lifted dividends benefiting from higher premiums and margins. Investors rewarded higher dividends when accompanied by earnings upgrades.

However, like earnings-per-share, aggregate FY25 dividends-per-share (DPS) were downgraded. Dividends were not downgraded as much as EPS as there is an expectation that aggregate payout ratios will rise. We suspect this may be because management teams are hoping to enhance their investment appeal via higher dividends. Despite this, a sluggish domestic and Chinese economy accompanied by a hawkish RBA may lead to more earnings and dividend downgrades over the next six months.

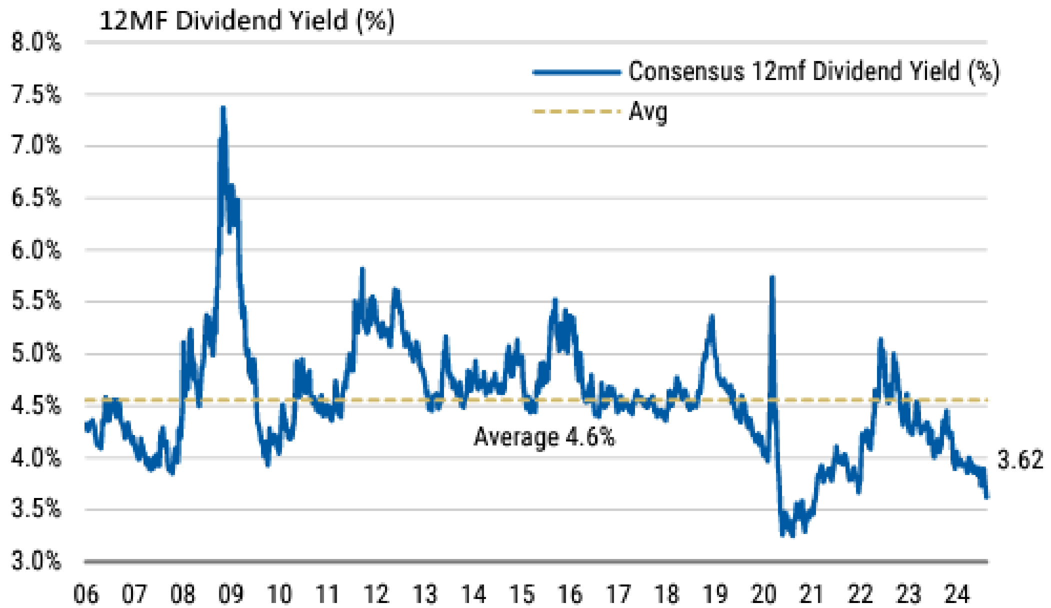
S&P/ASX100 – 2024 / 2025 Dividends-Per-Share (DPS) outlook revision history



Source: Barrenjoey Research, FactSet

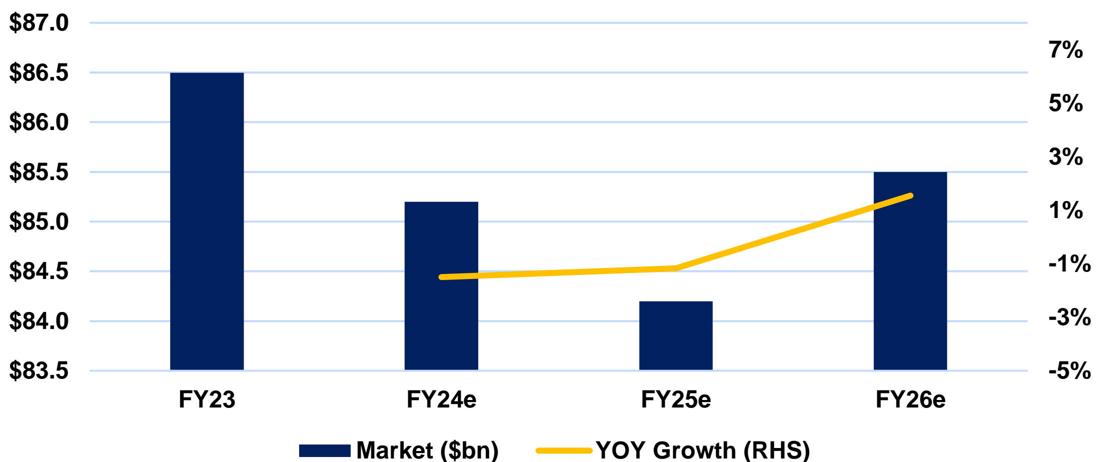
The market rally combined with lower dividends has meant that the dividend yield for the market is less attractive, tracking below historic levels.

ASX200 12-month-Forward Dividend yield



Dividends have fallen for the last two years from the lofty heights of FY22 mainly due to the fall in Resource company dividends. BHP, in particular, has led a fall in dividend payments. Lower commodity prices and higher costs and capital expenditure plans have impacted Resource company dividend payments.

Dividends are now expected to slightly fall in FY25F. Lower commodity prices will continue to impact Resource companies with dividends now forecast to fall in FY25F. Bank dividends are expected to be broadly flat while Industrial dividends are expected to grow.



Source: Citigroup, EQT

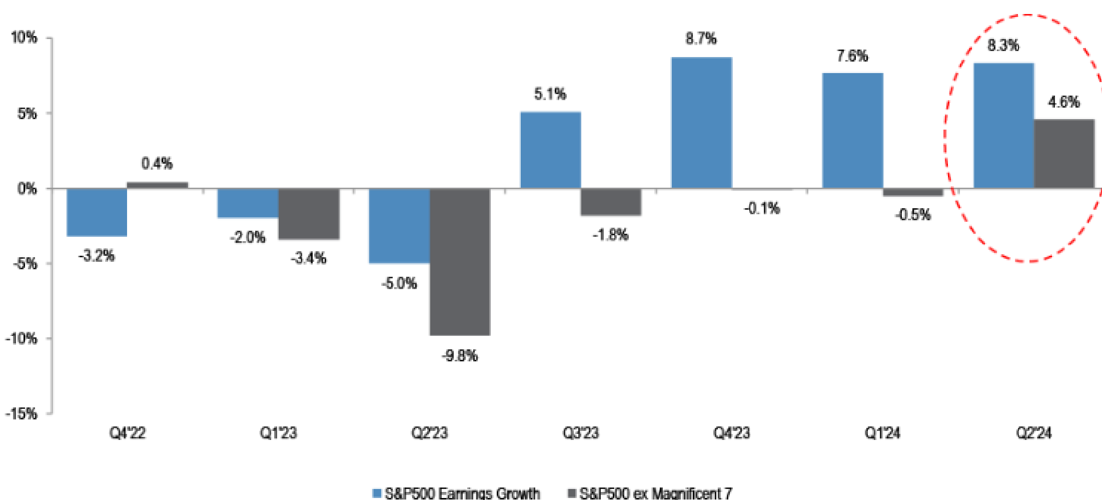
US Reporting Season takeaways

The US also experienced a solid reporting season. Key points to note included:

- Overall year-on-year (yoy) earnings growth was 11.7% - the highest in over two years – with most sectors delivering earnings growth above their long-term median levels. Earnings positively surprised by ~4%. Financials and utilities delivered the strongest positive earnings surprise.
- ~80% of S&P500 companies beat earnings expectations. This is broadly in-line with historic trends. However, the bar to positively surprise has risen and therefore often an in-line result saw a stock price decline.
- The Magnificent 7 posted ~38% yoy EPS growth for the quarter, relative to a +~32% expectation at the beginning of the reporting period. The other 493 aggregated to ~5.1% growth yoy for Q2 relative to a +3.6% expectation.
- Big Tech EPS surprise (~5.6%) was the lowest in the last 6 quarters. Nvidia (NVDA) posted its weakest EPS surprise (+5.4%) in the last seven quarters, along with modest sales guidance.
- 2Q24 was the fourth straight quarter that exhibited positive operating leveraged with earnings growth nearly double sales growth.
- Earnings delivery in the US has remained stronger than in Europe but is narrowing.
- Notably, however, the proportion of companies beating sales estimates fell indicative of a tougher economic environment. ~50% of S&P50 companies beat at the sales line. Sales rose a solid ~5.5% year-on-year and positively surprised by ~1%.
- There has been some weakness in consumer discretionary sectors highlighting a more discerning consumer. Like Australia, the lower end consumer has been impacted more negatively by higher rates and cost of living pressures while top quartile individuals have benefited significantly from higher equity markets and house prices.
- While the mega-tech names in general have produced another solid set of results, there has been more questions raised about the timing and potential return from the huge investment being made in Artificial Intelligence (AI) along with how much will continue to be spent.

BROADENING OF EARNINGS DELIVERY

Importantly, the US saw a broadening in earnings delivery. While the Magnificent 7 contributed positively, the other 493 stocks are contributing for the first time in six quarters. S&P500 earnings per share growth was positive even excluding the Magnificent 7 - the first time in 5 quarters.



Source: Bloomberg Finance L.P.

This is important because:

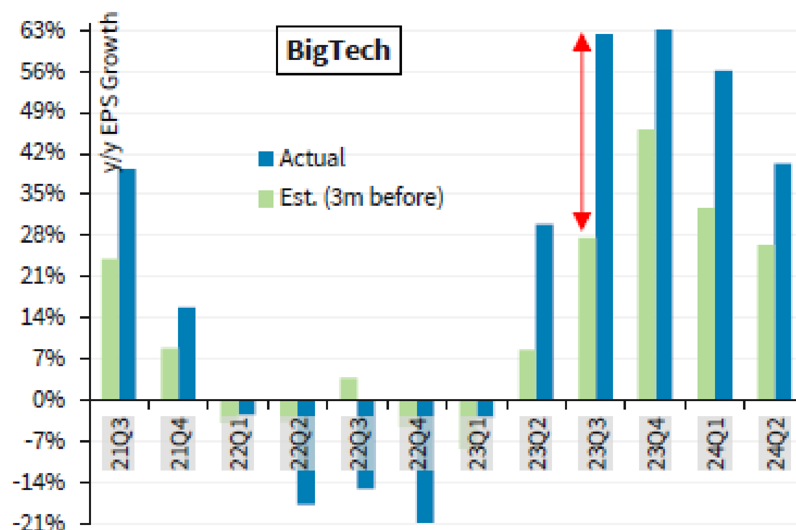
- We have recently been witnessing a rotation from the Mega-tech names into the broader market.
- Concerns about the narrow leadership may lessen.
- The market should be supported given broader growth drivers.

This creates opportunities for active managers in a range of other sectors that offer value.

Implications for the outlook of US equities

Despite delivering positively relative to Q2 expectations, 2H expectations have been reduced modestly. 2H year-on-year growth expectations fell, in aggregate, by 2.1 percentage points to +10%. Base effects, macro uncertainty and slowing mega-tech earnings growth will weigh slightly on near term growth rates. Recession risk has risen as labor markets exhibit some fraying at the edges. While this poses some risk to the 2H earnings set up corporates and many economic commentators are not expecting a major US recession. Expectations of a more aggressive Federal Reserve response have also grown that should start to support the economic environment in 2025.

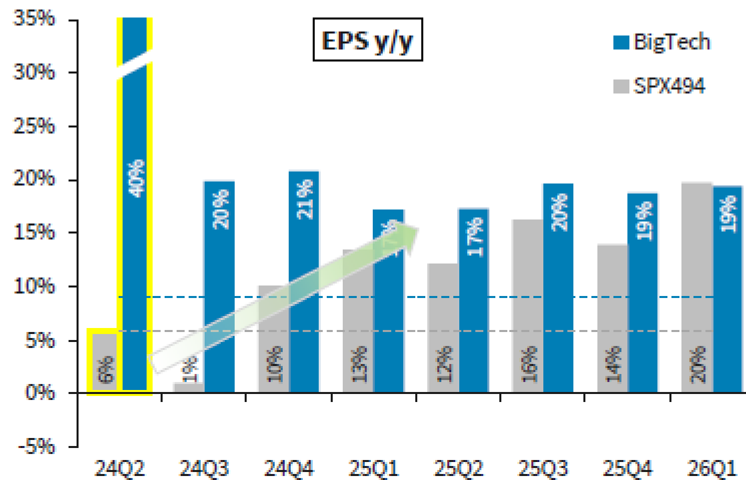
Despite this, the growth outlook for FY25 is strong, however the ability for mega-tech names to continue to positively surprise has lessened. The six Mega-tech stocks that have driven large-cap US equity earnings over the last two years are seeing a deceleration in both EPS surprise and yoy EPS growth. It has been that positive surprise and subsequent positive earnings revisions that have driven the US equity market gains over the last 12-18 months.



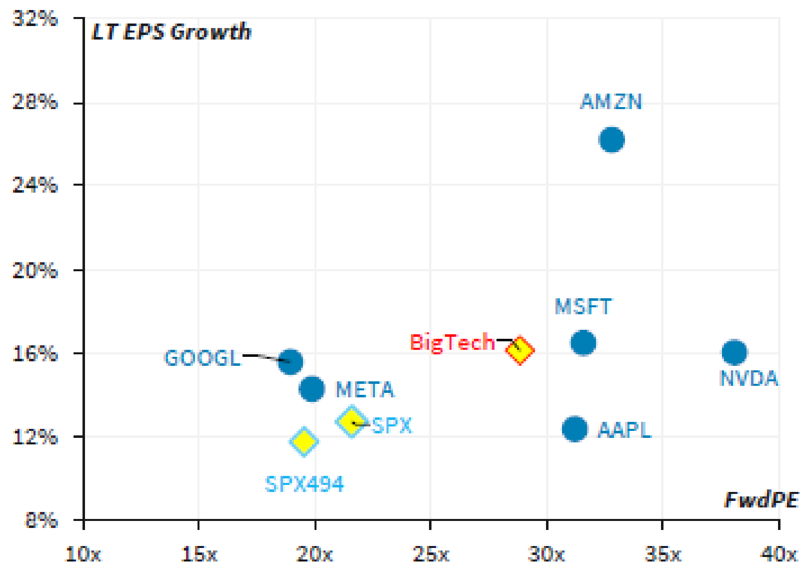
Data as of 8/30/2024
Source: LSEG Data & Analytics, Bloomberg, Barclays Research

The trajectory of near-term earnings growth remains solid as shown below. Consensus is currently expecting earnings to grow in FY25F and FY26F by double digit rates in the US (12-15% pa) driven by large tech, but also a broadening of earnings growth into other sectors.

Big Tech EPS growth is expected to fall in 3Q24 but remains solid in the medium term.



Valuations still appear a little rich overall impacted by high valuations of the Mega-tech names. However the major tech companies still offer strong earnings growth outlooks. This along with apparent value opportunities in companies leveraged to falling interest rates make active management at this point in the cycle an attractive feature in our view.



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