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Profits and the Australian economy – not bad!

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Key points

> The profit reporting season that just ended was reasonably good with profit growth expectations affirmed.

> While June quarter GDP growth slowed, it reflects pay back for unbelievably strong March quarter growth. Forward looking indicators point to a gradual pick-up in demand driven by a rebalancing in the economy.

> The combination of improving growth and low interest rates suggest the trend in Australian shares remains up.

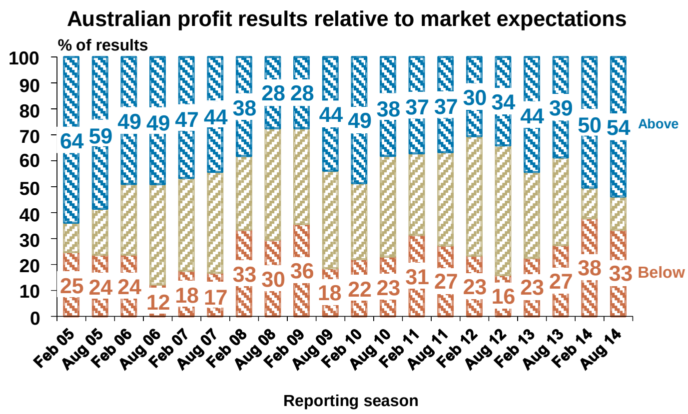
Introduction

The slowdown in June quarter GDP growth to just 0.5% quarter on quarter, or just 2% on a US style annualised basis, against the backdrop of weak commodity prices, the end of the mining investment boom and rising unemployment may add to consternation regarding the Australian economic outlook. And yet the local share market has been performing well. Is the outlook as bad as some fear or have shares got it right? Yet again the share market seems to have taken comfort from recent earnings results so I'll start there.

Profits not booming, but look reasonable

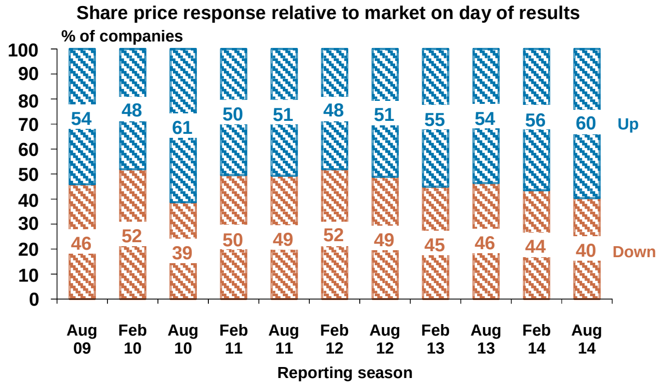
The June half profit reporting season just ended was preceded by nervousness associated with the falling iron ore price and the blow to consumer confidence associated with the Budget. In the event though solid growth was confirmed for 2013-14 and consensus earnings expectations for the current financial year were affirmed. In terms of specifics:

- 54% of companies exceeded expectations, which is the best result in nine years. This is a welcome outcome for investors who were probably fearing more misses;



Source: AMP Capital

- 68% of companies have seen their profits rise from a year ago (compared to a norm of 66%);
- 65% of companies have increased their dividends from a year ago (up from around 60% in the last two years); and
- 60% of companies saw their share price outperform the market the day they released results, the best in 4 years.

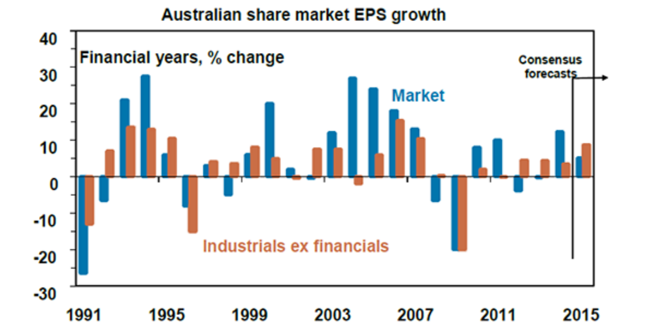


Source: AMP Capital

Key themes have been:

- strong profit growth of 25% for resources after a 19% profit slump as costs fell and volumes rose;
- financials doing well with 11.5% profit growth, helped by 9% growth from the banks and a 34% surge for insurers;
- ongoing cost control making up for still soft revenue growth resulting in 4% profit growth for industrials;
- mixed results for cyclicals – good for Boral, Stockland & Harvey Norman, not so good for JB HiFi; and
- strong dividend growth reflecting investor interest in income, strong cash flow growth and corporate confidence in earnings prospects. Dividends grew 7% after 11% growth in 2012-13.

Consensus expectations for the current financial year are for 5% earnings growth, which is unchanged from the start of the reporting season and presents a relatively low hurdle.



Source: UBS, AMP Capital

This reflects a slowing in resources profit growth to just 3% as lower commodity prices feed through partly offset by higher export volumes; bank and financials seeing profit growth slowing to 5%, but a pickup in profit growth for industrials ex-financials to 8.5%. Clearly the latter is depended on some pick-up in economic growth.

Soft June quarter GDP, but ok outlook

The slowdown in economic growth seen in June quarter may add to concerns about the economy. Particularly so with Australian Bureau of Statistics (ABS) business investment intentions data pointing to a fall in business investment this financial year of 9 to 10%. However, the broad outlook remains for a gradual improvement in growth. The poor GDP growth seen in the June quarter is pay back for the much stronger than expected 1.1% rise seen in the March quarter. This reflected noise in the timing of exports and imports such that trade boosted growth by 1.4 percentage points in the March quarter and detracted 0.9 percentage points in the June quarter. Given this it makes sense to average the two quarters giving average quarterly growth of 0.8%, or 3.2% annualised, which actually pretty good.

Of course, spending growth averaged over the two quarters is just 2.2% annualised which is hardly great. However, signs continue to mount that thanks to the fall in interest rates to record lows and to a lesser degree the lower $A, the economy is rebalancing towards more broad based growth.

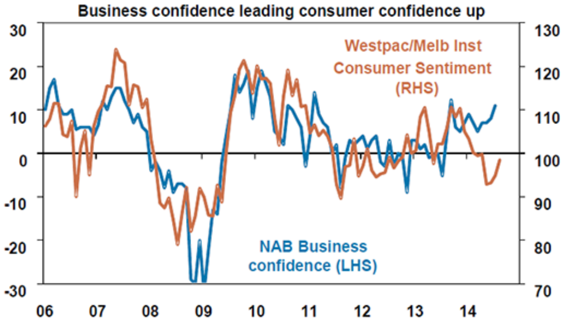
- A housing construction boom is now underway with home building up 8.6% over the last year and more on the way.

Building approvals are about as strong as they ever get

Source: Bloomberg, AMP Capital

- Business confidence has risen to solid levels and while consumer confidence took a hit from the Budget cutbacks scare, it seems to be clawing its way back up.

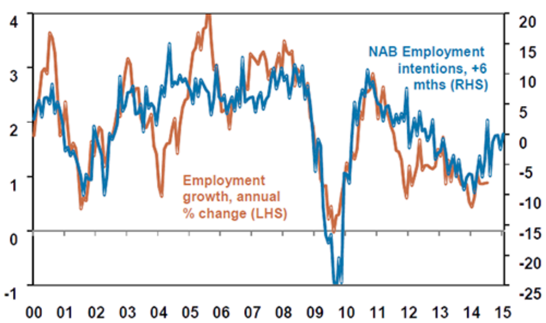
Business confidence leading consumer confidence up



Source: Bloomberg, AMP Capital

- A range of forward looking labour market indicators – ANZ and SEEK job ads, skilled vacancies and the NAB business survey are pointing up for jobs.

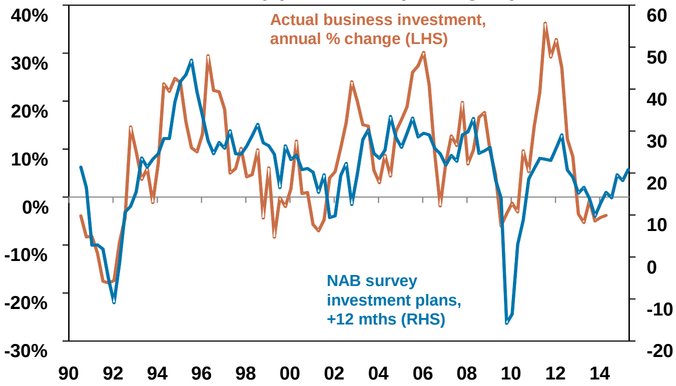
NAB survey points to improving employment growth



Source: ABS, NAB, AMP Capital

- Lower interest rates, rising wealth levels and rising housing construction is likely to drive a pick-up in retail sales with household equipment leading the charge.
- While the investment outlook for mining and manufacturing is bleak the outlook for investment in other industries is improving. Investment intentions for what the ABS calls "other selected industries" points to a 9% to 10% gain this financial year. And the NAB business survey's investment intentions index has actually started to rise pointing to stronger investment ahead.

NAB survey points to improving capex



Source: ABS, NAB, AMP Capital

- Finally, we are also coming into the third and final phase of the resources boom. We will see increased export volumes as projects complete and reduced capital goods imports as resource investment slows.

Drawing these factors together our assessment remains that underlying demand and growth in Australia is gradually on the mend and should be running around trend of just above 3% through next year.

Not "dog days"

The key to the Australian economy right now is rebalancing. The mining investment boom and associated surge in interest rates and in the $A that were necessary to make way for it, led to a dramatically imbalanced economy with half of growth coming from mining investment at one point. This clearly adversely affected big parts of the non-mining economy. With mining investment now fading, lower interest rates and in time further declines in the $A are allowing the non-mining economy to bounce back. This process is slow – and it would be aided by a reinvigorated economic reform agenda – but the indicators above suggest it's underway.

Implications for investors

First, the outlook for the economy is not nearly as gloomy as frequent headlines suggest. Profits are likely to record modest but reasonable growth over year ahead.

Second, interest rates are likely to remain on hold. Growth is not bad enough and there are enough signs rate cuts are working to argue against rate cuts. But the high level of uncertainty regarding the economic outlook, the still too high $A and low inflation argue against rate hikes. The most likely outcome is that rates will be on hold well into next year.

Finally, the combination of rising economic growth and continuing low interest rates should underpin a pick-up in non-resources earnings growth over the year ahead, which in turn should support further gains in the Australian share market. Our year-end target for the ASX 200 remains 5800.

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