MARTIN CURRIE AUSTRALIA

MARTIN CURRIE
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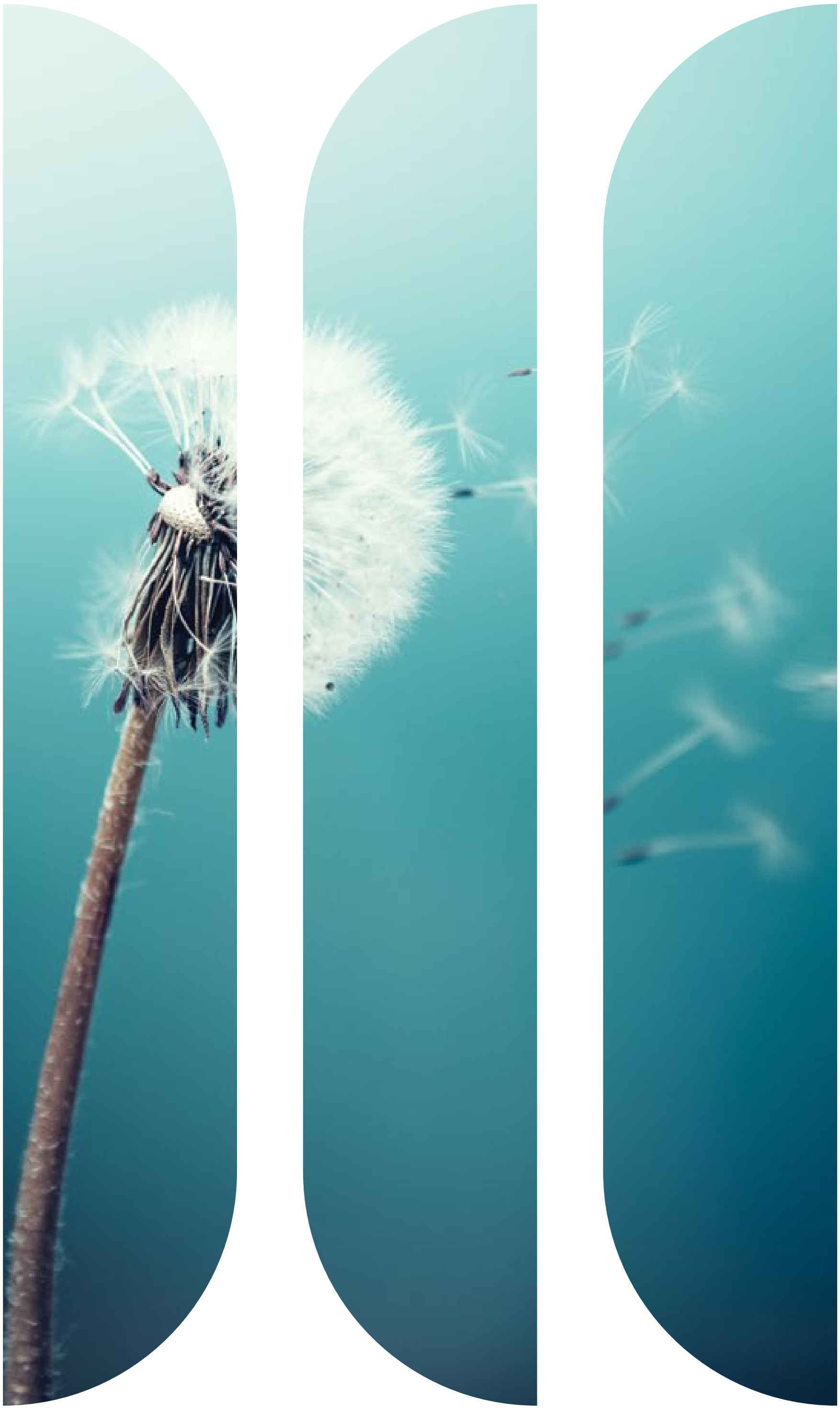


AUSTRALIAN REPORTING SEASON WRAP:

BE CAREFUL WHAT YOU WISH FOR...

Is the Australian market truly ready for the impact of falling inflation on company earnings? The Martin Currie Australia team, led by Chief Investment Officer Reece Birtles, have dived into the critical insights of the August reporting season, addressing the key questions facing Australian equity investors in FY25.

Reece Birtles, CFA, GAICD
Chief Investment Officer
Martin Currie Australia

Executive summary

Our biggest concern following our analysis of Australia's August 2024 reporting season is that the results and company communications seem to echo the poor conditions we experienced back in 2019, a period overshadowed by the subsequent Covid years. However, the market's stock price reactions appear to be disregarding any evidence that contradicts the 'Goldilocks' narrative for the economy, leading to rising prices without the support of earnings growth.

The market appears overly hopeful about the positive impacts of lower inflation and interest rates. On the other hand, macro data such as falling purchasing manager indices (PMI) readings and consumer confidence measures, the exceedingly negative management guidance, ongoing dividend conservatism and the tone of our company engagements and the rise of the 'value conscious consumer' suggest a need for caution and to really **be careful what you wish for**.

The market's exuberance has resulted in Valuation spreads between cheap and expensive stocks reaching near extreme levels. This dispersion has negatively impacted active manager performance over the past 12 months, particularly those exposed to Value factors. Yet, this presents an opportunity moving forward, despite the negative outlook as a whole. In today's environment of wide Valuation spreads and potential rate cuts, it is likely that today's cheap stocks will prove more defensive than the expensive Growth stocks.

While pinpointing an exact turning point in market sentiment is challenging, it remains crucial for investors to be discerning in their stock selection. Focus should be on companies with pricing power, resilient volumes, and the capacity to manage margins, while avoiding those with Valuation risk. We believe that Growth-style stocks remain expensive, while Value stocks are still cheap relative to historical standards. As the large spread between Value and Growth unwinds and the market refocuses on Valuations based on true earnings fundamentals, the conditions for Martin Currie Australia's (MCA) style strategies to outperform their total return and/or income objectives remain convincing.

Definitions

What we do each reporting season

For us, the focus of reporting season for the MCA investment team has always very much been on the fundamentals. This period provides heightened news flow from companies via their results and the engagements we have with boards and management.

In addition, we use our analysis of the drivers of how company results came in compared to consensus broker expectations (surprise), the extent to which these brokers revised their forecasts for earnings in the next 12 months (revisions), and how stock prices reacted to that news to judge the overall pulse of the market more logically and better understand the real fundamental drivers of the price response.

This aggregated analysis allows us to assess the themes across the market that would be 'hard to see' when looking at each company result in isolation and apply our insight at the stock and portfolio level.

Key definitions used in our top-down analytical review

Surprise: The difference between company reported results and broker consensus forecasts. Above/below is where the average difference is >+/-2%.

Revisions: The change in broker consensus next 12-month (NTM) forecasts after companies have reported their results. Up/down is where the change is >+/-2%.

-12m: prior 12 month actual.

LTM: last 12 months actual.

NTM: next 12 months broker consensus forecast.

Disclaimers for data and content throughout

The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.

Unless otherwise noted, data is calculated using the weighted average of broker consensus forecasts of each portfolio holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed and may differ materially from the figures mentioned. The figures may also be affected by inaccurate assumptions or by known or unknown risks and uncertainties.

For broker consensus data, the number of brokers included for each individual stock will depend on active coverage of that stock by a broker at any point in time. A median of brokers is typically utilised. All estimates avoid stale forecasts which are removed after a certain number of days.

Market defies economic backdrop to reporting season

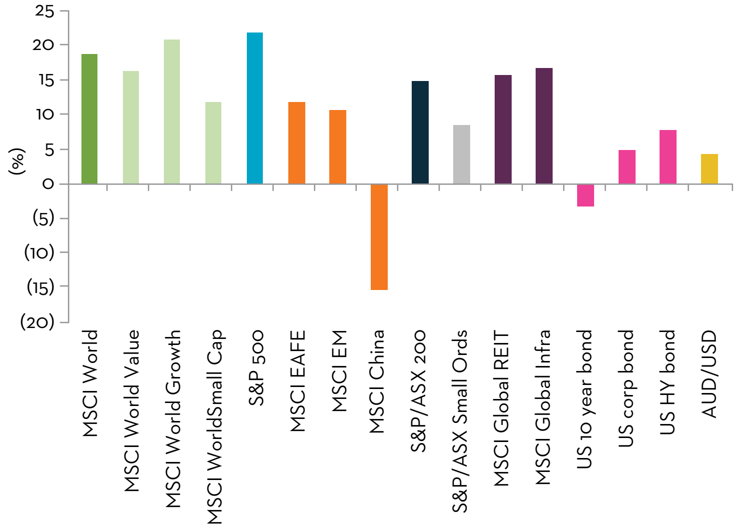
The August 2024 reporting season felt like a roller coaster for market movements. It began with a Japan carry trade driven sell-off and a 'flight to safety'. By the end of the month, it felt like things had returned to where they started, with the market back to being driven by the momentum style bias that has been omni-present over the last six months.

The last 12 months' returns for the key indices also indicate that the market is behaving as if a 'Goldilocks' economic landing, discussed in our last reporting season paper, is actually possible. This gives some context to the wild ride in August. After that minor stumble at the start of the month, both share prices and global earnings per share (EPS) growth expectations have continued to rise on the back on the Artificial Intelligence (AI) hype in the US, allowing price to earnings (P/E) ratios for the market to stay high on a historical basis.

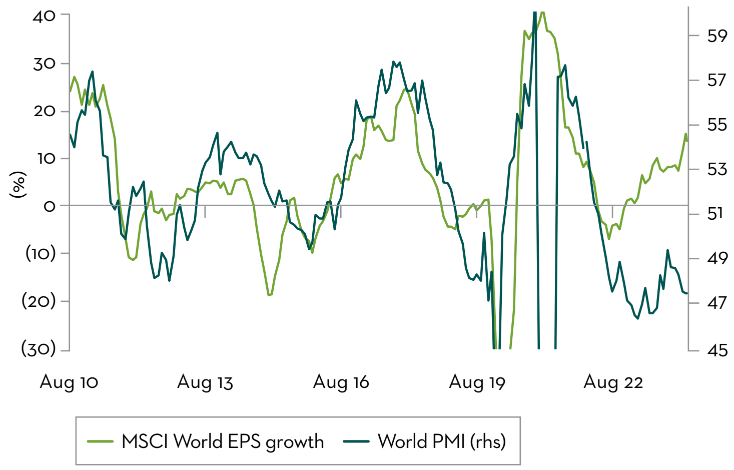
However, when we contrast the share market exuberance with what we are hearing in Australian results and macro indicators, we see a huge disconnect. The sub-50 levels of PMI, the deflation in commodity prices, falling China demand growth, and poor business and consumer confidence readings suggest that EPS growth for companies should be quite negative, indicating a potential recession. Historically, the worst market performance is typically seen when rates are getting cut. Currently, the markets are wishing for rate cuts, implying that inflation is falling but growth is going to reaccelerate. The market is ignoring any evidence that is contrary to this 'Goldilocks' story.

Interest rates in the US remain very restrictive, and the yield curve is inverted. History suggests that US GDP growth will slow after inversion, and with the Federal funds rate above pre-GFC levels on a real basis (Treasury Inflation-Protected Securities), this suggests the slowdown must happen soon. Globally, the risk of recession is building. In Australia, while inflation will likely come down in line with the market's wishes, the RBA will ultimately need to cut interest rates, not because inflation is under control, but because unemployment is starting to rise.

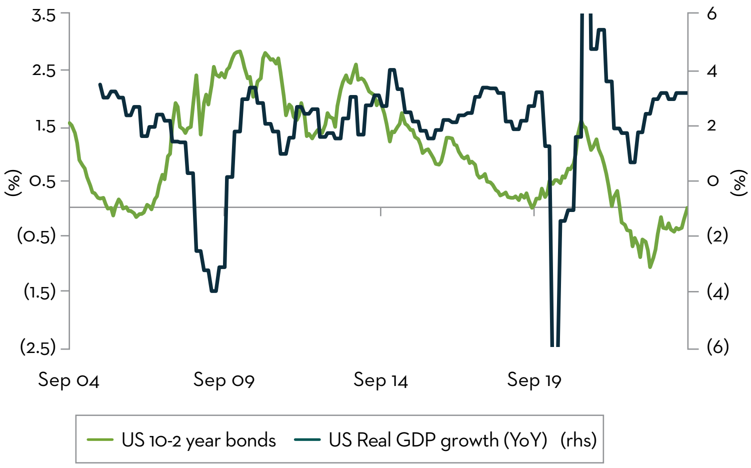
12-month index returns



World: expected NTM EPS growth and PMI



US: Treasury yield spread and GDP growth



Past performance is not a guide to future returns.

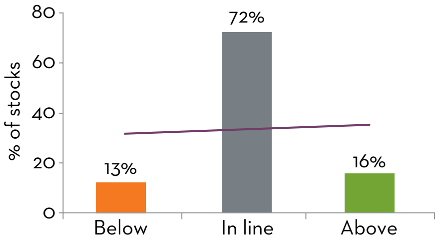
Source: MCA, FactSet, MSCI; as of 31 August 2024. Index returns are shown in Australian dollars.

Analytical and fundamental review of results suggests weak earnings outlook

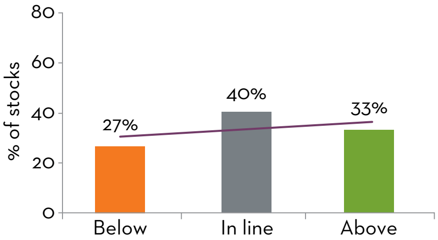
Results were mostly in-line

Across the S&P/ASX 200 stocks we cover, 33% of company results beat the consensus forecasts on an EPS basis, while 27% missed the expectations from the lead in. There were slightly positive trends in the sales per share (SPS) and dividend per share (DPS) lines. With beats marginally ahead of misses, this confirms there were 'no problems in the rear-view mirror'.

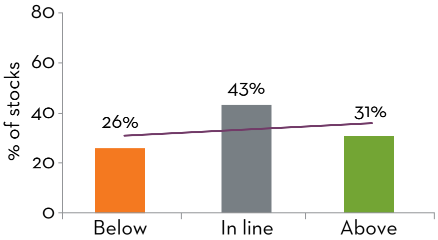
Sales surprise: % of companies



EPS surprise: % of companies



DPS surprise: % of companies



The skew of these results was quite similar to the last three reporting periods back to February 2023 in that they were soft but weren't weak. This contrasts with 2019 where we last saw materially weak results versus expectations.

- The most positive beats came in from companies in the *packaging* space, such as **Orora**, **Brambles** and **Ansel**. This was because we appear to have seen the end of the destocking issues that were occurring in fast moving consumer goods, and their pricing power had held up margins. The *banks* also reported more resilient net interest margins and loan losses, with bad loans not increasing despite the slowing economy. *Tech* stocks also had quite positive surprise, particularly in EPS. For them it was more about controlling costs than improving revenues. *Discretionary* retailers came in marginally ahead, mainly in lines lower down in the profit and loss statement.
- The most negative misses were in what we call *commodity processing* names, such as **Sims**, **BlueScope Steel**, **Ampol** and **Viva Energy Group**. In this area we are seeing quite a bit of 'exported deflation' from China due to their excess capacity issues. Beyond that, it tended to be a bit more stock specific, with names such as **Ramsay Health Care**, **Spark New Zealand**, and **Aurizon Holdings** also providing disappointing misses with their results.

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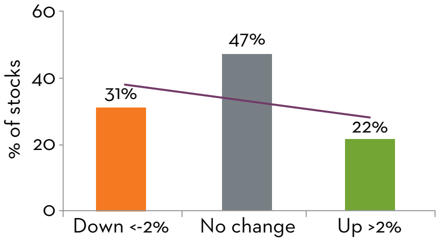
Source: MCA, FactSet; as of 31 August 2024. Data shown for the S&P/ASX 200 Index.

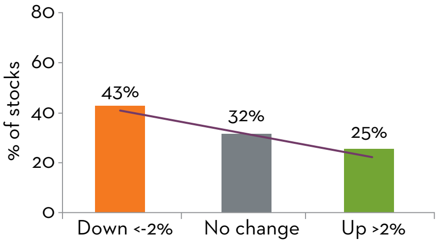
Management guidance and forecast earnings revisions suffered a downgrade skew

However, after assessing the tone of management guidance for the important line items, we see a two to one negative skew of guidance cited below what brokers were expecting before the results.

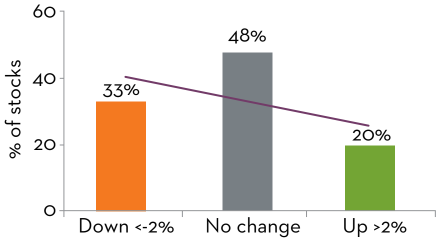
Sales revision: % of companies



EPS revision: % of companies



DPS revision: % of companies



Looking at how brokers have revised their next 12 months forecasts, not surprisingly, they closely fell in line with the negative guidance, leading to more than 40% of companies receiving downgrades to their EPS forecasts versus only a quarter receiving upgrades.

- The worst companies were very much in the *resources* space. This was driven by weaker commodity prices across iron ore, lithium and copper and the like, as well as energy. There was also weak guidance on production problems which is driving lower volumes and higher unit prices for a number of the miners.
- The *cyclicals* also had quite weak revisions, be it in housing stocks such as **Fletcher Building**, **James Hardie Industries**, **Reliance Worldwide**, media stocks **Seek** and **Nine Entertainment**, or discretionary services names like **Dominos** and **Tabcorp**. Healthcare names also showed up again with both **Ramsay** and **Sonic** seeking downgrades.
- The *REITs* had quite negative downgrades, especially the office exposed stocks such as **Dexus** and **LendLease Group**.

The biggest driver of the weak guidance from management was the slowing inflation environment that everyone seems to be wishing for. The result of this is a less desirable, slowing sales environment. For the first time since August 2020, we saw a downgrade skew to the SPS line, which had been much more resilient until now due to inflation. This slowing sales environment, sitting at around 2% p.a. growth, is making it a lot harder for companies to maintain or grow EPS.

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Source: MCA, FactSet; as of 31 August 2024. Data shown for the S&P/ASX 200 Index.

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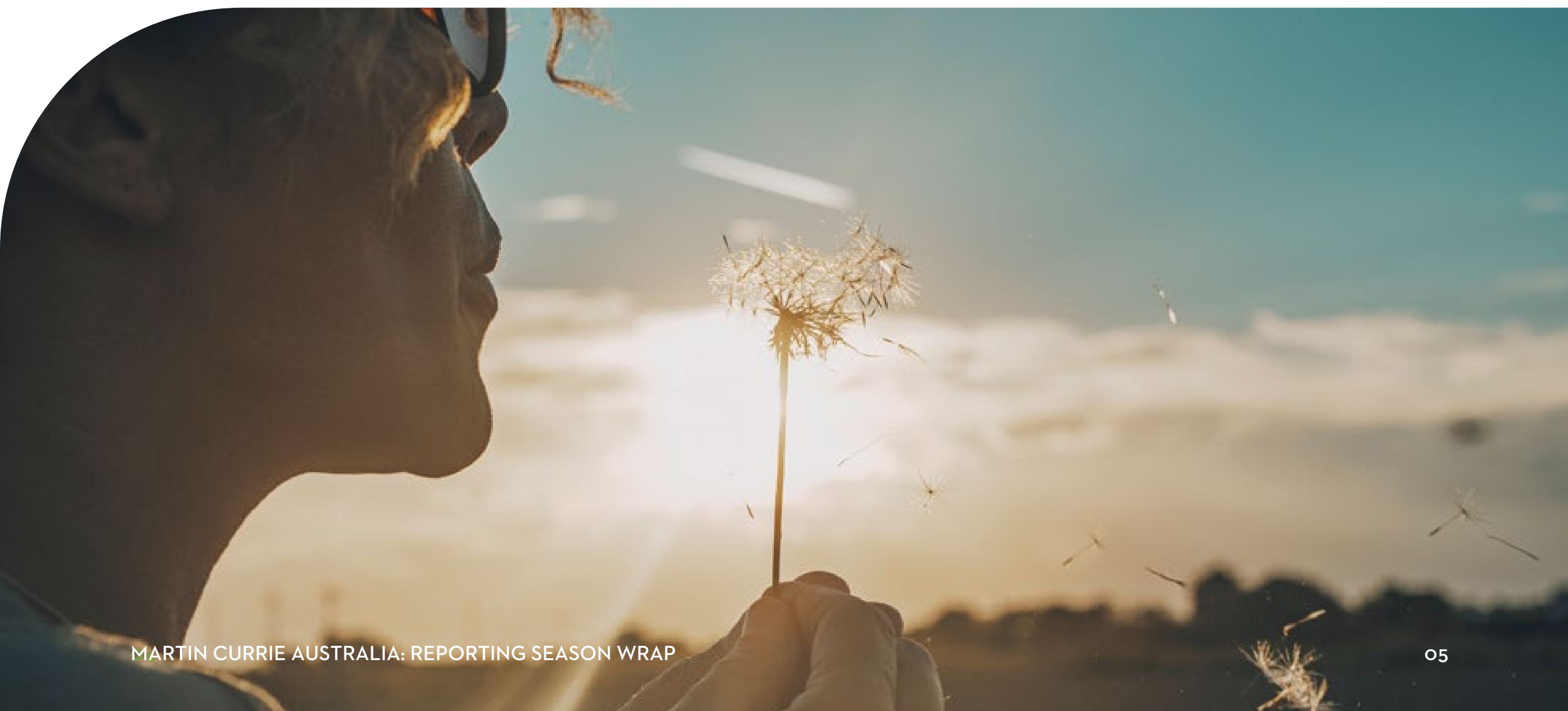

Insight gained through company interactions.

Our 100+ meetings and engagements with company management teams during the reporting period provided additional insights to the results and management guidance, and help us to further refine our investment views and outlook. The key topics that have echoed across sector lines included:

- **Consumer demand** weakness has now joined **business demand** weakness as a key issue. In previous reporting seasons business demand had already weakened but consumer demand had been resilient.

  One of the key topics in the *consumer* space was that all the companies were talking about the 'value conscious consumer'. One supermarket we spoke to said that they are seeing this value orientated behaviour in even their most premium suburbs. Another company we spoke to that has good analytics on this topic was identifying that the behaviour of people under 35 is also very different to those over 35. In prior periods, the demand resilience was more distinct between renters and mortgage holders versus the rest. Finally, another anecdote from a CEO of one of the big consumer stocks noted a negative change in consumer behaviour in the last eight weeks.

  One area that continues to defy the slowdown is *travel*. All related companies that we spoke to continue to see very strong demand indications for travel, with volumes now surpassing pre-Covid levels.

- Given slowing inflation and poor revenue growth, **pricing power** and **gross margin management** have saved the results of many *industrial* companies, but with selling prices falling it is making for quite a difficult margin expansion environment for many companies going forward.

  One of the things about slowing inflation is that it has been concentrated in goods prices rather than those for services. The public sector crowding out the private sector is creating ongoing inflation in the services area. Goods focussed companies have benefitted from lower Cost of Goods Sold. They have managed to reduce promotional activities, and remix the shopping basket toward cost or own-brand products, and that has benefitted their gross margins. The *banks* also demonstrated good pricing power on deposit pricing. They have managed to retain a lot of the benefits as rates have risen and as the competition impacts on mortgages have passed. Albeit delayed, the *real asset* companies are also now seeing the benefit of inflation pass throughs into tariff increases.

- **Labour** has gone from one of the top headwinds to earnings, in terms of shortage and cost, to no longer being a constraint, or to even being an opportunity. In fact, we have identified 15 companies that are now talking about cost out opportunities with reasonable large-scale reductions planned. We are still seeing some supply side constraints with big government infrastructure projects taking all the trades away from residential or private construction. We are still hearing stories of 15% price increases for subcontractors in trades in Victoria, stories of companies not going ahead with store refurbishments or opening new stores because they cannot get a builder at a reasonable fixed price contract

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- Everyone is talking about **Artificial Intelligence** (AI), but what we find interesting is that no one is really talking about the large language models. What they are referring to is more akin to old school machine learning, the same things that have been available for the last 15 years, just a bit bigger and maybe outsourced to a software as a service (SAAS) company. What we are hearing is that if we outsource to SAAS then it's an 'AI project'. Real on the ground AI was missing from the conversation apart from limited examples where long documents are scanned by AI.

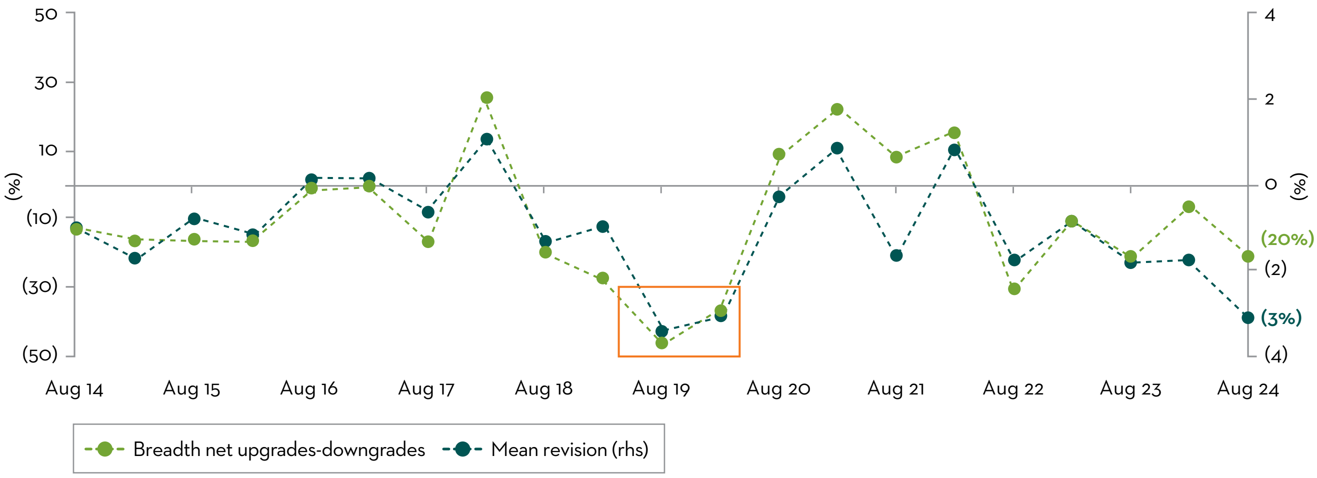
- In terms of **ESG**, the biggest issue cited by management included concerns for social/cost of living issues (which is ironic given the price increases) and delays to new energy rollouts. We are hearing that it is getting harder to get new projects through to final investment decisions because the project economics are looking poor without government subsidies. Another concerning issue that we also flagged in our recent ESG outlook is how the number of fatalities in the heavy industry areas has been increasing in recent years.

- **Regulatory issues** were also a bourgeoning topic in this period, with several companies citing a negative impact from intervention on competition grounds, and difficulties getting environmental approvals.

The environment is looking like 2019

Putting those revision downgrades into context, the net breadth of the number of companies receiving upgrades versus downgrades was somewhat negative, but we note that it was not terrible versus recent history. However, the size of the mean EPS revision (-3%) was the worst since 2019 and the second worst for the decade.

EPS revisions over time



While this poor revision statistic is in part driven by the concentration of the S&P/ASX 200 in the large cap miners who experienced commodity price downgrades, and weakness in demand from China's excess capacity, it is truly a signal of where we are in the economic cycle.

That low point in 2019 was when economic conditions were slowing, earnings and profit expectations were being cut, and rates were getting cut. Covid seems to have distorted the market's collective memory of how bad these conditions were, and we are seeing similar conditions now.

Past performance is not a guide to future returns.

Source: MCA, FactSet; as of 31 August 2024. Data for the S&P/ASX 200 Index.

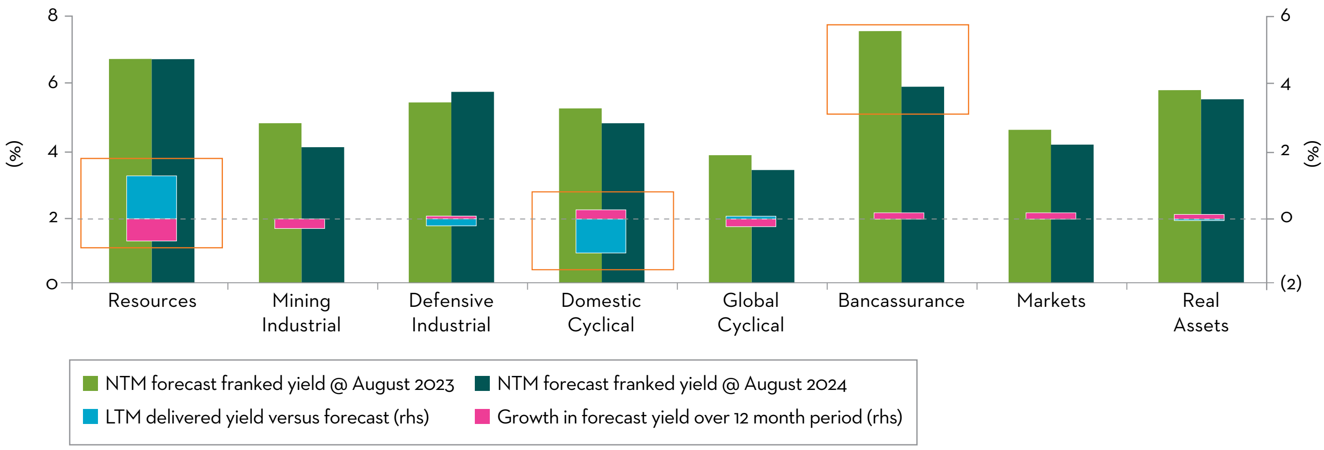
Income scorecard reflects slowing environment

We have also updated our Income Scorecard to capture any changes post reporting season in earnings and dividend expectations. The scorecard allows us to track how sectors and individual companies have delivered on the market's forecast dividend expectations over the last 12 months, and if their dividend expectations are providing any inflation protection or growth expectations. Our scorecard allows us to look more closely at the potential income outcomes for the type of higher quality income opportunities within the S&P/ASX 200 that we consider for inclusion in our retirement income-focussed portfolios.

In our analysis we limit the universe to focus on results of true income opportunities only, those that meet a minimum franked yield threshold, and our proprietary assessment of sufficient quality and liquidity for an income investor. This leaves us with around 100 stocks out of the S&P/ASX 200.

We also strip out the impact of stock price movement when looking at the growth in forecast yield over the last 12 months by assuming a static stock price based on the start of the period. This allows us to see if the changes in yield are due to true earnings expansion or just share price changes. Looking at the winners and losers from a pure income perspective, rather than stock price performance, more closely aligns with how we think about portfolio construction for our retirement income-focussed portfolios.

Scorecard for MCA's income universe: by economic sector



In keeping with the slowing sales and earnings environment, we are also seeing poor DPS outcomes over the last 12 months, and ongoing subdued growth expectations across the sectors:

- A key highlight over the past 12 months is that the *resource* stocks have continued to deliver good dividends versus expectations 12 months ago. However, the outlook is a lot tougher now, and most of the downgrades in future dividends can be found in this sector.

  A particular stock of concern is **Woodside Energy Group**, where their M&A decision to invest in two new projects in the US have put a lot more stress on their ability to have enough free cash flow to fund strong dividends going forward.

- The other standout concern was with the *banks*, which did deliver good earnings results, and reasonable or flat dividends over the last 12 months. However, there has been no growth to their forecast DPS because the underlying fundamentals haven't improved. The only thing that has changed is share prices.

  Commonwealth Bank of Australia is a prime example of this. The bank is now at a level that is hard to call a strong dividend paying stock. The price being paid for the Bank at this point is unprecedented, and as a result the yield has dropped to below even the bond yield. To us, there is no fundamental basis for its P/E ratio, apart from the weight of passive investors creating a supply / demand issue. This has resulted in everyone analysing the price rather than the fundamentals. We warn people to remember that bubbles never last.

- *Domestic Cyclicals* suffered from lower dividends over the period as Covid stimulus has unwound, however some of these stock prices have performed well as EPS/DPS results were somewhat better than feared by the market.

Past performance is not a guide to future returns.

Source: MCA, FactSet; as of 31 August 2024. Data shown for the MCA income universe: based on S&P/ASX 200 stocks with at least a 3% expected franked yield based on broker consensus forecasts, and pass our proprietary assessment of sufficient quality and liquidity for an income investor. Franked yield assumes zero percent tax rate and full franking benefits realised in tax return.

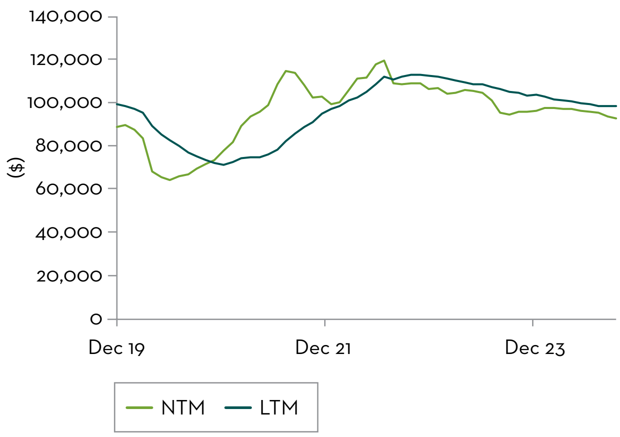
Concerns flowing into further dividend conservatism

A concerning trend overall for dividends is that companies are becoming even more conservative, in both their payout ratios, and also the level of debt ratios that they are willing to run. The average payout ratio across the market has dropped from 62% pre-Covid to 53% now, and companies have similarly dropped their amount of debt/revenue from 33% to 22%.

This hoarding of retained earnings, which is also not being reinvested into growth areas or areas with the highest return, is a worry for us. The lack of pressure being put on boards and management around payout ratios in recent times is a byproduct of the momentum driven market and the lack of scrutiny on fundamentals. Once the momentum bubble bursts, we do expect to see a return to dividends, and more focus on improving shareholder value.

- There were several companies that lowered their payout ratio further, and unfortunately, this really does signal earnings stress. We saw this action from **Mineral Resources**, **Dexus** and **Insignia Financial**.
- There were also a few signs of positive capital management activity examples during the period. These included special dividends from **JB Hi-Fi**, **Super Retail Group** and **Lottery Corporation**. We also saw improved payout ratios from **Chorus**, **Commonwealth Bank of Australia** and **IGO**, and buybacks from **South32**, **Brambles** and **Aurizon Holdings**.

S&P/ASX 200: Aggregate Dividends (A$ millions)



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Source: MCA, FactSet; as of 31 August 2024. Data for the S&P/ASX 200 Index.

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Muted profit growth expectations amid extreme Valuation spreads

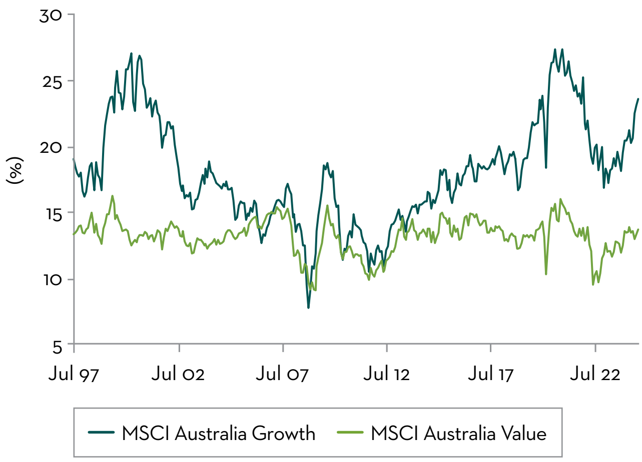
Combining the results, guidance, revisions and fundamental insight gained from engagement and the macroeconomic reality, we are left with a less-than-ideal outlook for company profits. The forecast for next 12-month profit growth for the S&P/ASX 200 is down to just 2%, with the most negative expectations in the *resources* space, and most positive in *industrials*. However, given the slowing sales growth environment, we do question how much more of that growth can be wrung from gross margin expansion.

Despite the poor profit outlook, the market remains disconnected from this impending reality. We are witnessing a situation where Valuation spreads between the cheap and expensive stocks in the market, either by simple P/E measures or our proprietary Valuation research, are back at near extreme levels. There have been only three points in recent market history when the Valuation spread has been this wide: pre-dotcom bubble, GFC and Covid.

This dispersion has hurt active manager performance over the past 12 months, and particularly managers exposed to Value factors. However, this is where we see the opportunity is going forward. In today's environment of wide Valuation spreads and potential rate cuts, it is likely today's cheap stocks will prove more defensive than the expensive Growth stocks.

While it is difficult to pick an exact turning point in market sentiment, we believe that now is the time for investors to evaluate the balance in their portfolios. This environment can be navigated, but it is as important as ever for investors to be discerning in their stock picking.

MSCI Australia: Next twelve month P/E ratio



Past performance is not a guide to future returns.
Source: Martin Currie, FactSet; as of 31 August 2024.

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Strategic positioning for the conditions

Portfolios across our range of Australian active equity strategies are based on MCA's Valuation and risk discipline. We continually adjust our portfolios based on the information we are getting from sources, including the reporting season results, company meetings and engagements. These interactions provide valuable opportunities to refine our investment thesis for each company.

In the current market environment, characterised by the wide Valuation spreads and potential rate cuts, we believe that today's cheap stocks will prove more defensive than the expensive Growth stocks. Our focus remains on companies with pricing power, resilient volumes, and the capacity to manage margins, while avoiding those with Valuation risk.

Value Equity (Select Opportunities)

For some time, we have positioned our Value Equity portfolios for a hard landing scenario. We have lowered the beta of our portfolios and are focussed on companies that can grow earnings and have lower Valuation risk. Normally its said that risky stocks are the ones that are cheap, but at the moment, safe is actually not expensive.

We are finding undervalued names that have defensive business characteristics or profit drivers less related to the broader economic cycle such as:

- **South32**, which has undertaken a significant business transformation focussed on copper and other materials needed for the energy transition;
- **Worley**, who will benefit from increased spend in renewables in future years; and
- **Flight Centre Travel Group**, who has made significant business efficiency improvements and is seeing ongoing demand growth.

Active Insights

In our Active Insights strategy, we seek to remove style risk, such as value, growth or momentum, and focus our positioning on stocks where our investment team's insights are most unique, and unexplained by any common factor and super sector risks. Pure alpha stocks may not always be cheap on a traditional 'price to book' basis, but stocks where our analysts have identified a differentiated outlook.

After minimising unnecessary style factor and sector risks relative to the S&P/ASX 200, stocks that we find attractive for their 'pure' alpha potential include:

- **Brambles**, who have significantly increased their pricing and are holding on to that pricing power;
- **Ventia Services Group**, which is growing earnings at double-digit levels in infrastructure services; and
- **Scentre Group**, who is benefiting significantly from the constraint in available new retail space alongside strong tenant demand.

Equity Income

In the income space, we are looking for companies that can continue to support fundamentally higher franked dividends over time. We are focussed on identifying high-quality names with strong dividend yields and a defensive outlook. The structured diversification of the portfolio also means that we are structurally under-weight the top 20 ASX stocks, and higher dividend risk sectors such as resources and the banks.

Key income opportunities include:

- **Atlas Arteria Group**, a defensive company with decent yield and growth from toll regimes that benefit from inflation and long-term debt hedging;
- **Bendigo** and **Adelaide Bank**, who is transitioning its cost base and delivering earnings growth; and
- **Telstra Group**, who is benefiting from ongoing pricing power for their mobile plans.

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Source: MCA, FactSet; as of 31 August 2024. Data presented for the MCA Value Equity, MCA Active Insights and MCA Equity Income representative accounts.

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The analysis of Environmental, Social and Governance (ESG) factors forms an important part of the investment process and helps inform investment decisions. The strategy/ies do not necessarily target particular sustainability outcomes.

Risk warnings – Investors should also be aware of the following risk factors which may be applicable to the strategy shown in this document.

- Investing in foreign markets introduces a risk where adverse movements in currency exchange rates could result in a decrease in the value of your investment.
- This strategy may hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the strategy's value than if it held a larger number of investments.
- Smaller companies may be riskier and their shares may be less liquid than larger companies, meaning that their share price may be more volatile.
- The strategies mentioned may invest in derivatives (index futures) to obtain, increase or reduce exposure to underlying assets. The use of derivatives may restrict potential gains and may result in greater fluctuations of returns for the portfolio. Certain types of derivatives may become difficult to purchase or sell in such market conditions.
- Income strategy charges are deducted from capital. Because of this, the level of income may be higher but the growth potential of the capital value of the investment may be reduced.

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