Research

26 July 2021

MACQUARIE

Investment Strategy Update #64

Reporting season – Uncertain outlook shouldn't cloud improving fundamentals

- The August reporting season will tell us a lot about the past six months, however the timing of the most recent lockdowns and uncertainty around their duration will make forward guidance difficult for many corporates. **We expect some will back away from giving guidance, with others likely to widen guidance ranges.**

- As we have seen during prior lockdown periods, **the market tends to look through speed bumps on the road to recovery.** Lockdowns and their economic impacts have proven temporary, and we doubt corporates will be discounted for backing off forward guidance. We believe the most recent lockdowns are delaying the re-opening of the economy, but policy settings are helping to cushion the blow. In our view, a fully reopened economy still offers upside for the equity market.

- We think the August reporting season will highlight some **very positive underlying trends, with profits recovering strongly for cyclical areas,** as evidenced by the strong and consistent earnings upgrades seen since the February reporting season. However, profit expectations have normalised and do not incorporate the recent hiccup to reopening. As such, a period of softer guidance and potentially negative revisions to current expectations is likely.

- **Expect to see evidence of a strong revenue rebound and tight cost control for cyclicals** as well as insights into how corporates are now managing rising input costs (both labour and commodities) as an indication for how close peak margins are. In addition, attention will be placed on pricing power and any evidence that cost increases are already being passed through. Dividend increases, signs of a shift in consumption of services and environmental, social and governance (ESG) considerations should also feature.

- **We believe resources, mining services, healthcare and technology will be highlights this reporting season,** reflecting solid end-market demand, elevated commodity prices and ongoing structural tailwinds. We expect consumer services and travel will be most heavily impacted by lockdowns, but this is largely in expectations.

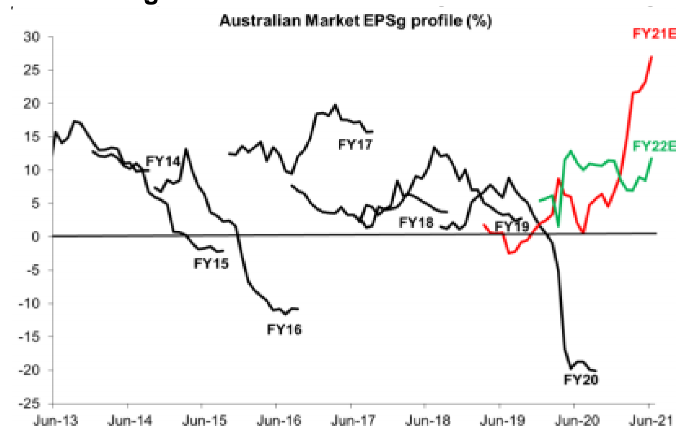
- Overall, the reporting round may be clouded by an uncertain outlook, however **we see this as a temporary blip in the cyclical recovery**. Monetary policy settings are ultra-accommodative, vaccination rates are picking up and the global economy continues to recover – albeit at differing speeds given recent COVID-19 outbreaks. Australian corporates have recapitalised, are running lean, are benefiting from elevated confidence and are leveraged into rising demand. Fears of peak margins due to rising input costs will be a gradual progression.

What is Macquarie expecting?

July marked the 11th consecutive positive earnings revision month for the Australian equity market. Macquarie is forecasting FY21 earnings per share growth of 28%, boosted by significant upgrades in resources and banks and if realised, this would be the strongest annual earnings growth in more than a decade.

While the bounce back in FY21 growth is encouraging, it largely reflects a rebound (normalisation) post the sharp drop suffered in FY20. We expect to see positive earnings surprises through the reporting season if the trends leading into the result season hold. However, more recently we have seen a deterioration in revision momentum and we expect recent lockdowns to carry some downside risk for forward guidance through reporting season – in particular, impacted sectors such as services and travel.

FY21 EPS growth reverses the FY20 decline



Source: Macquarie Research, July 2021

Key themes for August reporting season

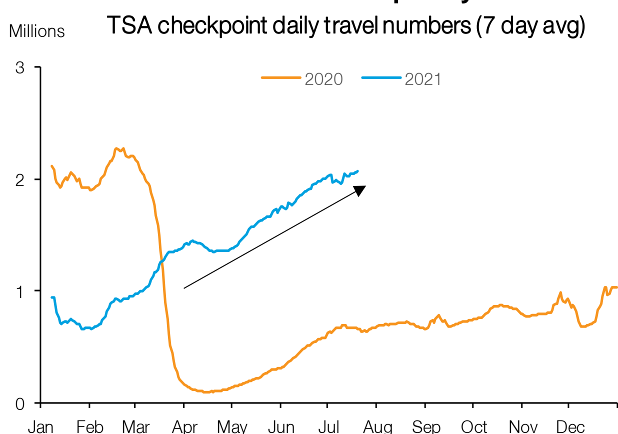
We expect the following key themes for August reporting season:

1. Leverage to cyclical upside: We expect to see a strong rebound for many domestically and globally exposed cyclicals, as well as areas leveraged into commodity prices. While the rebound in cyclical earnings will differ depending on mobility constraints, we expect investors to remain focused on how companies are positioned for the recovery irrespective.

Offshore markets provide good visibility on how demand may recover domestically (eg US airline traffic) and we expect re-opening stocks to be well supported despite patchy results and/or a lack of clear guidance. A miss on results could cause a sell-off, but **weakness is likely to be temporary** given the re-opening of the economy is simply on pause.

Companies with international or more-defensive end-markets will for the most part be better positioned than domestic cyclicals. Certain sectors (eg construction, office, retail, travel) are likely to signal earnings headwinds but this is likely to be temporary and we suspect there is a large contingent of investors who will be prepared to look through near term headwinds. While management teams are likely to adopt a more cautious tone given the duration of current lockdowns is unknown, it has not proved to be a large constraint to performance over the past 12 months for those with longer term investment horizons.

US airline travel has recovered quickly

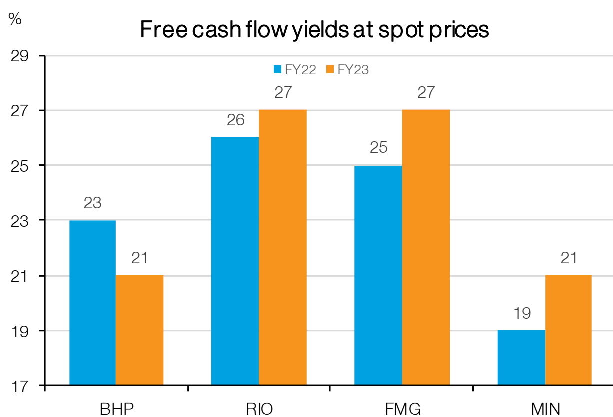


Source: www.tsa.gov, MWM Research, July 2021

2. Rising dividends and capital returns: Earnings will rebound strongly through 2H21 and dividends will follow with most companies recapitalised and in a much better position than 12 months ago. Miners are in an exceptionally strong position to pay out super-sized distributions, due to minimal gearing and an iron ore price that has averaged above US$200/t in recent months.

Company results are typically a catalyst for analysts to mark to market commodity price assumptions. With consensus expectations for iron ore still well below current spot levels, **we see further upside risk for FY22 earnings** as the upgrade cycle continues should spot pricing remain resilient. We see potential for upgrades and stocks to outperform the market should spot prices rise, stay flat or even ease back slightly.

Miners cash flow generation support elevated yields



Source: Factset, Macquarie Research, July 2021

Given the current climate, it is possible companies more exposed to the economy hold-back on dividends/capital returns. Commonwealth Bank (CBA, Underperform) will be watched closely as the only bank to report in August with expectations for an off-market buyback. We believe the banks have plenty of *capacity* to return capital, but could delay capital management until the domestic outlook has improved.

3. Strong margins gains but downside pressures building: Most corporates have managed costs aggressively since the onset of the pandemic and, as the economy has re-opened, are now reaping the benefits via margin expansion. However, we are now seeing signs of rising costs and supply constraints which will be a key focus for margins as we go forward. In particular, this applies to pressure from rising commodity prices, ballooning transportation costs, labour shortages, which are pushing wage and salary costs higher, and more recently the lower Australian dollar (for importers).

Sectors and companies already experiencing labor shortages include: mining and mining services - Rio Tinto (RIO), Fortescue Metals Group (FMG) and Mineral Resources (MIN); agriculture - Costa Group (CGC); and construction – Austal (ASB). Rising input cost pressures have also been seen across areas such as packaging and consumer staples from higher raw materials eg – Amcor (AMC) and Unilever (ULVR), as well as construction eg Fletcher Building (FBU). It is harder to gauge who might be suffering from a lack of pricing power, but we may see signs of this emerging in areas such as construction and even within consumer staples given the demand outlook.

Longer-term, we expect the global recovery to provide a supportive backdrop for companies to pass on costs – but it is currently too early to tell how broadly this will apply. We expect high quality businesses with pricing power will be best positioned to pass on costs. However, input prices have risen so quickly it may be difficult to maintain short-term margins even for companies with wide moats.

Our view is inflationary pressures remain transitory with price pressures to stabilise as growth rates peak and supply bottlenecks are addressed (eg lumber has already declined 62% from its peak in May).

4. Rotation from goods to services (and back again): The goods sector has outperformed in the last year with online retail and home consumption key areas of strength. Recent lockdowns are likely to see these companies continue to report solid FY21 results and trading updates for early FY22. However, we expect goods consumption to give way to services as the economy reopens. This presents a potential earnings headwind for 2020's winners and will remain the primary focus for investors ie, solid trading updates may not translate to stock outperformance given concerns that this theme is now coming to an end.

The services sector is likely to see mixed results. Conditions were supportive through most of 1H21, but relative to goods, there may be some downside risk to guidance following recent lockdowns. Despite this, **we expect investors will price in a recovery for services** as visibility on the domestic vaccine rollout improves. In contrast, we believe upside for goods sectors has mostly peaked as the sector begins to cycle through year on year comps and as re-openings progress.

5. The rise and rise of ESG: We expect ESG to be a key area of discussion across all companies during August reporting season:

- **Divesting of non-ESG assets:** The trend of divesting non-ESG assets has accelerated in recent months (eg coal, liquor, oil, gaming) and will likely continue as the rise of ESG investing places mounting pressure on companies to sell or spin-off these assets.

- **Decarbonisation commitments:** Corporate decarbonisation commitments are accelerating, but with only ~40% of the ASX100 committing to a net zero target (and only 20% across our coverage of 245 companies), there is clearly scope to do more.

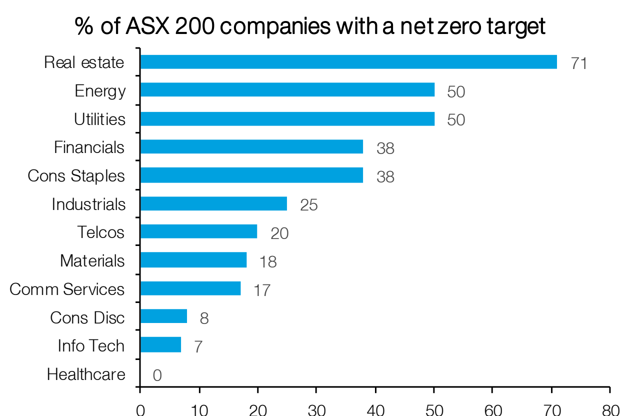
- **The promise of sustainability:** The adoption of sustainable business practices will be highlighted across energy efficiency, clean energy sources (eg hydrogen, solar, batteries), sustainable sourcing and social benefits.

- **Social factors brought to the forefront:** Employee wellbeing will be a key focus area as, unlike last year, there is no JobKeeper and job markets have been relatively tight ie what is the strategy for staff retention.

The global pandemic has driven an acceleration in ESG trends across the corporate landscape. In particular, environmental and social factors have been given a strong tailwind as lockdowns have broadened the focus towards stakeholder value. At Macquarie's recent 2021 Australian Conference in May, there was an ESG slide provided by every corporate that presented – the first time ever and a strong indication of where this trend is headed.

We expect ESG investing trends to accelerate. We believe companies that do not adopt and integrate ESG best practices will risk becoming non-investable for ESG funds which could ultimately translate into lower valuations and a higher cost of capital. ESG compliance and governance have become fundamental expectations for investors, as well as stakeholders and communities, and we expect this to be a major focus area for companies in the years ahead.

Expect more companies to commit to 'net zero'



Source: Macquarie Research, July 2021

Overall, we think there will be some encouraging trends to be highlighted in the August reporting season particularly around the speed of the rebound and margin expansion in areas exposed to the re-opening trade. While the latest lockdowns will drive a more cautious tone to guidance, the cyclical recovery is still intact – just delayed by recent events. While guidance is likely to be conservative, we think investors will continue to look to the medium-term potential for earnings to rebound.

We think 2020's winners will be dealt with more harshly if earnings disappoint given elevated valuations and earnings. For many companies, it is still not clear how much of the last year's earnings bump is a one-off and how much is a structural benefit that will extend into future years. Any earning's misses are likely to see investors de-rate companies and question the durability of earnings despite structural tailwinds.

We highlight Domino's Pizza (DMP, Underperform) as a stock with challenging comparative sales, elevated expectations, rising costs (ingredients, wages), and a valuation multiple that has more than doubled since 2019.

Macquarie WM Investment Strategy Team

The report was finalised on 26 July 2021.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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