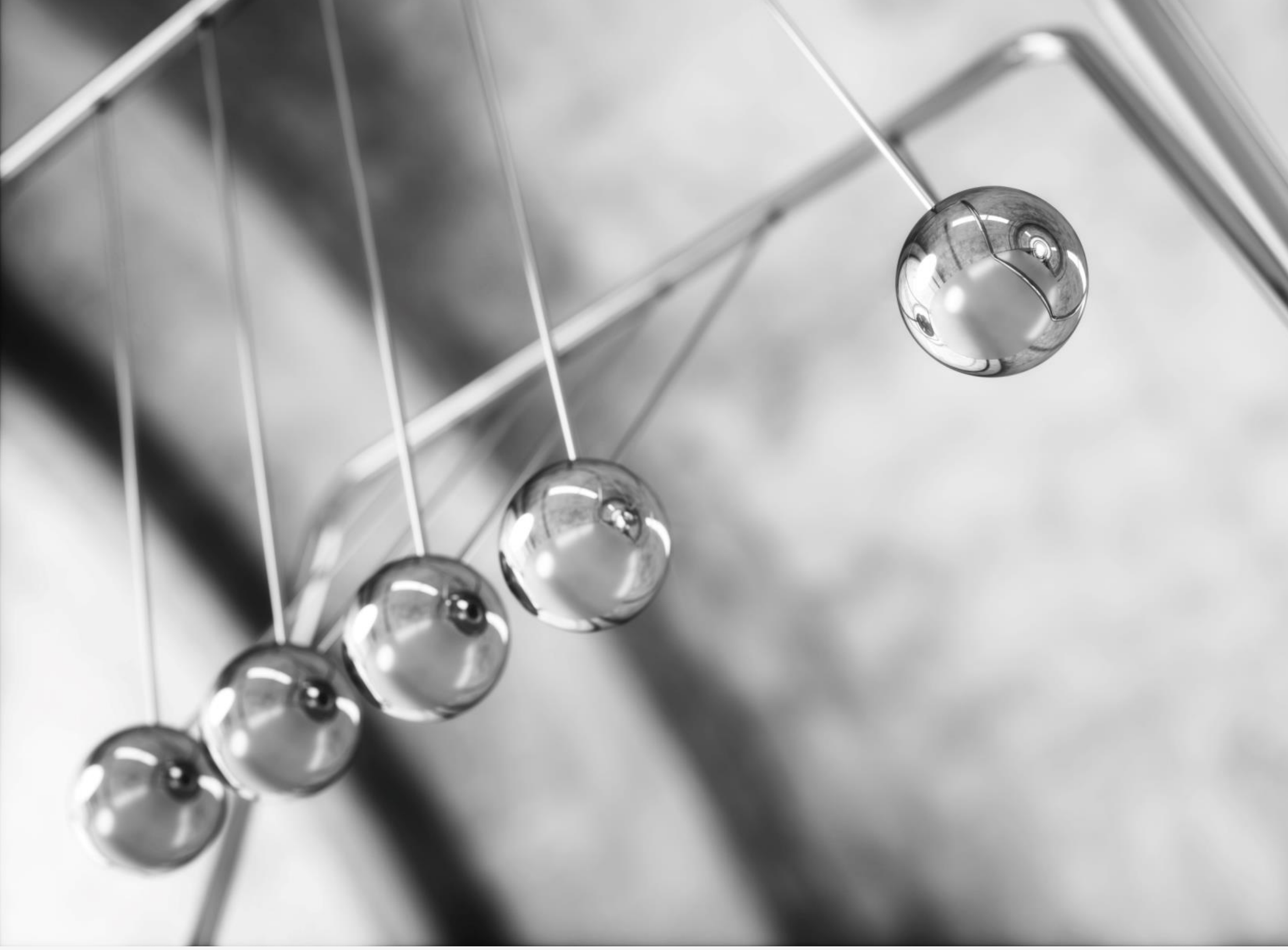


Earnings momentum – keeping an eye out for the peak

Our weekly view on Australian Equities

22 July 2021

The Australian earnings cycle remains strong

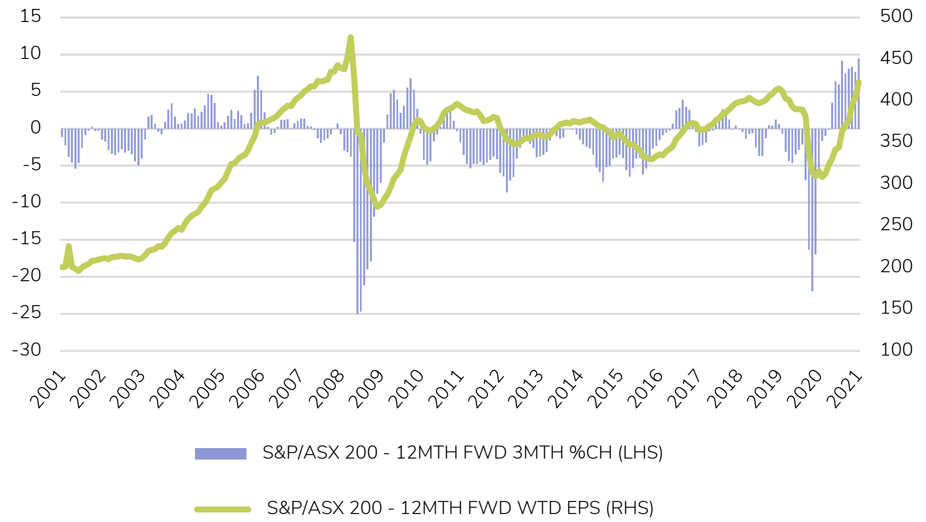
Since October 2020, the earnings cycle has gone from strength to strength. Consensus earnings revisions have now been positive for over 9 months - the longest period since the GFC.

Earnings have done much of the heavy lifting. Both the S&P/ASX 200 Index and forward earnings estimates now sit higher than pre-COVID level highs. Cyclicals have led from the front with uninterrupted earnings growth due to high commodity prices and an improving (reopening) domestic outlook.

However, investors are now asking themselves whether growth is peaking and, if so, what are the consequences for portfolios? Earnings are a key factor in determining share prices and a loss of momentum could potentially stifle the equity market that has been grinding higher over the last month.

Currently, earnings momentum could be an even more important factor as the market grows more concerned about the inflation outlook, central bank tapering and the new COVID delta variant.

Exhibit 1: 12mth forward earnings expectations have increased to decade highs



Source: Refinitiv, Wilsons

Exhibit 2: ASX 200 Performance is generally weak after earnings momentum peaks

Source: Refinitiv, Wilsons. Index price moves, no attribution for dividends.

What has history shown?

Since the GFC, there have been three periods of strong positive earnings momentum in 2010, 2011 and in 2017.

Our analysis shows that there is generally a period of negative returns or consolidation at an index level for the equity market after earnings momentum peaks. It typically takes ~3-4 months to move from peak to negative earnings momentum.

More parallels can be drawn between today and 2010, during the expansionary period post the GFC.

Both periods had strong earnings momentum after broad-based weakness during the GFC/COVID. Similarly, a powerful commodity cycle has led the way in terms of positive earnings revision momentum.

As a result, the 2010 post-GFC period should provide us with a guide or roadmap for markets after earnings momentum peaks, which will potentially transpire within next the 3-6 months.

During 2010, the market generated gains in both the 3 and 6 month periods before earnings momentum peaked. However, the market contracted by ~11% in the first 3 months after the peak.

Cyclicals underperform after earnings momentum has peaked

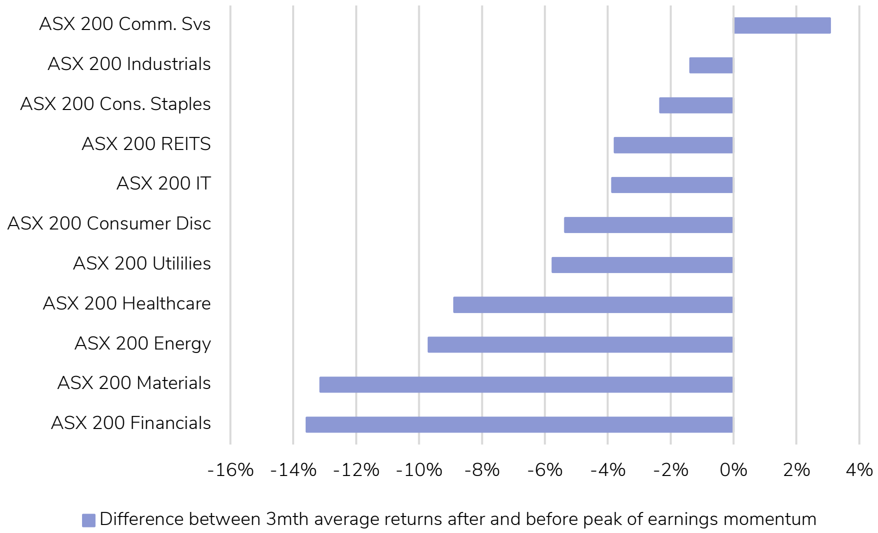
As earnings momentum peaks and rolls over, cyclicals are historically the most sensitive to this shift. At the same time, the growth or defensive sectors should start to outperform once the market turns a corner on momentum. However, there is typically a negative initial response from most sectors, delivering a period of uncertainty.

Earnings momentum has supported the reflation trade

The reflation trade has carried value stocks to above pre-COVID levels, and since the end of November 2020, value has outperformed growth as an investment style.

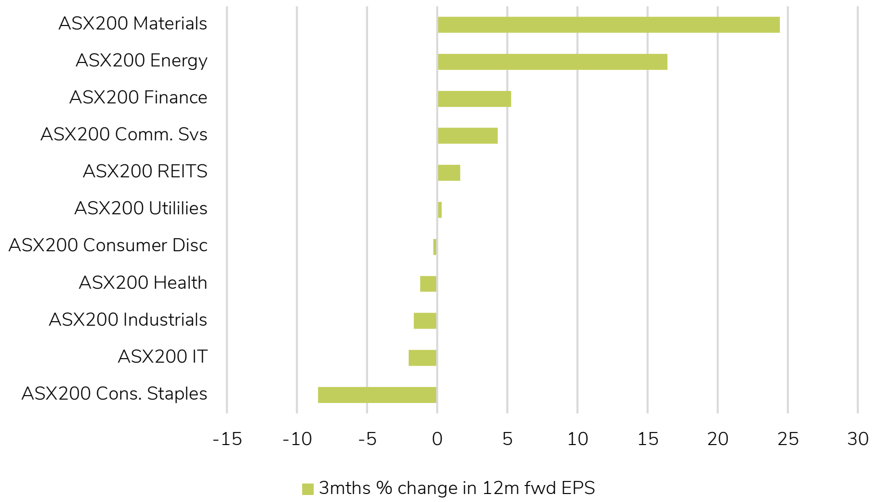
However, if earning growth rates start to peak, we could see a rotation back towards growth. With earnings momentum at very high levels, there is now a growing risk that growth has peaked, and the market will struggle to sustain this momentum over the next 6-12 months. Since March, we have already seen some of this rotation, but it has become more pronounced over the last month as growth concerns have crept into the market's thinking.

Exhibit 3: Cyclicals lose leadership post peak earnings momentum



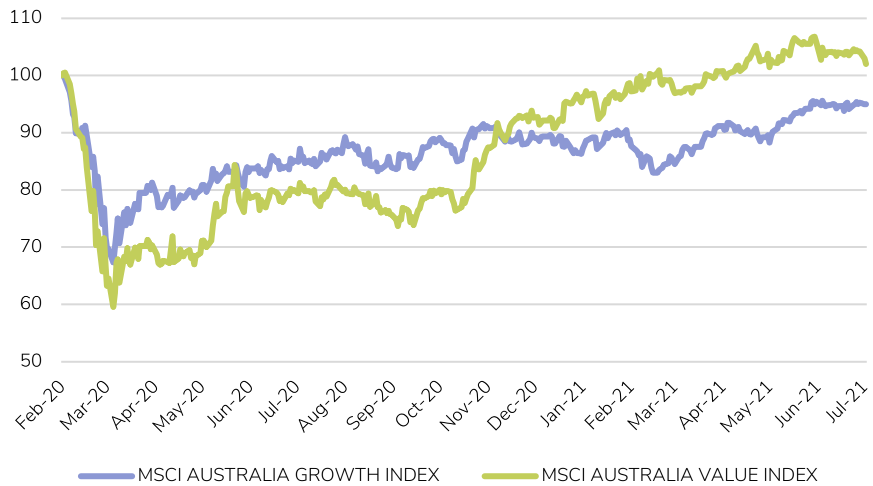
Source: Refinitiv, Wilsons.
Average 3mth returns taken around peak earnings momentum in 2010, 2011 and 2017.

Exhibit 4: Earnings momentum has been the strongest in cyclicals



Source: Refinitiv, Wilsons

Exhibit 5: Earnings momentum in cyclicals has continued to support value's outperformance of growth



Source: Refinitiv, Wilsons

This time it's different

We believe that we may reach peak earnings momentum this quarter, however, it is possible that this expansion phase is longer than in other periods, notably 2010. Our view is premised on:

1) Stronger global stimulus than post the GFC.

2) A commodities cycle that we believe is still in the first half of expansion

3) The economic recovery is likely to take another 6-12 months as the world reopens.

If earnings keep growing, albeit at a slower rate than over the last 6 months, we believe the market will not get too spooked to reverse the reflation trade, although outperformance may moderate

There is still upside in cyclicals

After a very strong rebound, we believe that the risk-return trade-off is not as favourable for cyclicals as it was at the beginning of the cycle. However, our base case remains that the overriding theme of the next 12 months will be the reopening of the global and domestic economies (notwithstanding a hiccup with the current lockdowns), which should provide significant impetus to the earnings growth cycle.

We remain constructive that this period of positive earnings momentum can continue in the medium term. Financials should see further earnings upgrades over the next 6 months as banks are expected to announce buybacks (ANZ have this week). In materials, elevated levels of copper and iron ore prices will likely support further earnings momentum. Both these sectors could push the index EPS higher and support the reflation trade.

As we go into the FY21 earnings season, we still expect to see further consensus upgrades – US reporting season is already providing evidence of upside surprises. Additionally, FY23E forecasts look to be too low. After analysts emerge from the FY21 reporting season, we believe that FY23E earnings could be upgraded, offering another tailwind for cyclicals.

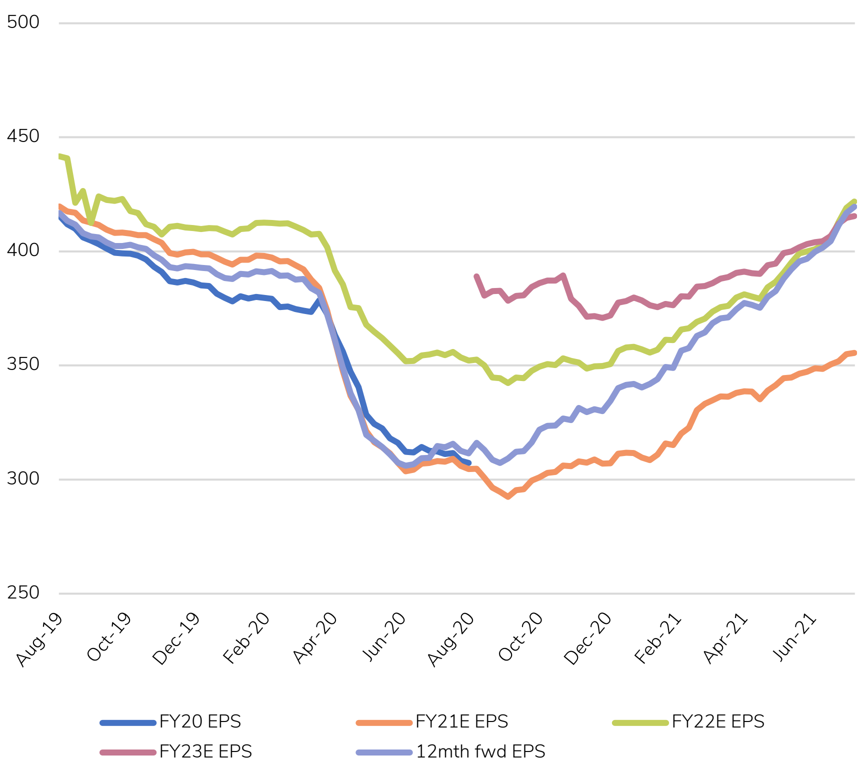
Focus List positioning

In November 2020, the Wilsons Australian Equity Focus List was ~70% weighted towards cyclicals. Although we still believe this cycle will stay the course, we have trimmed our weighting to cyclicals to ~60%, with the view that the risk and probability of history repeating itself (earnings momentum fades) is worth respecting.

Over the last quarter, we have increased our holding in **CSL (CSL),** a quality growth stock, and added **Telstra (TLS)** as a low beta, defensive stock. Removing **Super Retail (SUL)** and **Reliance Worldwide (RWC)**, two cyclical, COVID winners.

We have not changed the Focus List with reporting season beginning at the end of July. However, we will remain heavily focused on our positioning relative to where we are in the cycle, as we believe this to be key to outperformance over the next 12 months.

Exhibit 6: The ASX 200 FY23E EPS appears to be too low, with consensus implying earnings fall from the end of FY22E



Source: Refinitiv, Wilsons

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures

Disclaimer

This document has been prepared by Wilsons Advisory and Stockbroking Limited (AFSL 238375, ABN 68 010 529 665) (“Wilsons”) and its authors without consultation with any third parties, nor is Wilsons authorised to provide any information or make any representation or warranty on behalf of such parties. Any opinions contained in this document are subject to change and do not necessarily reflect the views of Wilsons. This document has not been prepared or reviewed by Wilsons' Research Department and does not constitute investment research. Wilsons makes no representation or warranty, express or implied, as to the accuracy or completeness of the information and opinions contained therein, and no reliance should be placed on this document in making any investment decision Any projections contained in this communication are estimates only. Such projections are subject to market influences and contingent upon matters outside the control of Wilsons and therefore may not be realised in the future. Past performance is not an indication of future performance.

In preparing the information in this document Wilsons did not take into consideration the investment objectives, financial situation or particular needs of any particular investor. Any advice contained in this document is general advice only. Before making any investment decision, you should consider your own investment needs and objectives and should seek financial advice. You should consider the Product Disclosure Statement or prospectus in deciding whether to acquire a product. The Product Disclosure Statement or Prospectus is available through your financial adviser.

Wilsons and Wilsons Corporate Finance Limited (ABN 65 057 547 323, AFSL 238 383) and their associates may have received and may continue to receive fees from any company or companies referred to in this document (the “Companies”) in relation to corporate advisory, underwriting or other professional investment services. Please see relevant Wilsons disclosures at www.wilsonsadvisory.com.au/disclosures. In addition, the directors of Wilsons advise that at the date of this report they and their associates may have relevant interests in the securities of the Companies.

All figures and data presented in this report are accurate at the date of the report, unless otherwise stated.

Wilsons contact

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.com