Equity markets
recovery to continue

Columnist: Don Williams, Platypus Asset Management chief investment officer

The main positive for investors to take out of reporting season was that earnings numbers were, in aggregate, better than expected. For the 2009 fiscal year, earnings estimates were increased by 2-3 per cent and by a very small amount for the 2010 fiscal year. Furthermore, there will be additional increases for 2010 when analysts revise their commodity price forecasts upwards as there is currently a significant gap between spot prices and forecasts for 2010.

This largely upbeat reporting season seems to have surprised some market commentators who have remained resolutely bearish despite the ongoing upward momentum in the market. This negativity has in fact intensified in recent weeks because September is historically the worst month for equity markets.

However, our view remains that further shocks to the system are unlikely as central banks and governments are very much in control at the moment and will do whatever it takes to sustain markets and economies.

The upwards movement in the share market should be considered in the context of the size of the move down, and how markets have recovered from similar episodes. So far this recovery rally is typical and should have further to go. Furthermore, very little 'new' money has been put to work, either by institutions or at the retail level, so there are still large sums of money waiting to be invested.

Clearly the market will run out of valuation support eventually and we see that level at around 5000 on the S&P/ASX 300 Index, but if the earnings environment or prospects have improved by that time, then it could continue beyond this level.

Those who remain worried about a correction should keep an eye on money market spreads and the volatility index, which currently seem to be behaving well.

Nonetheless, the recovery remains fragile and profits are still going backwards. Therefore it is vital the government keeps in place everything that has been announced in its stimulus package. The ongoing recovery depends on consumer and business confidence remaining relatively buoyant. If programs are cut, it will put the recovery at risk.

In my view, it is extremely unlikely the Reserve Bank of Australia will increase interest rates before it has the chance to see how the economy (especially retail) performs without the direct fiscal stimulus packages.

Recent economic data has been weak – for example, full-time employment just fell by another 27,000 jobs, which implies companies are still adjusting their cost structures.

Retail sales have declined from a 7-plus per cent growth rate to 4 per cent in the past two months and it is hard to forecast the trend from here. In fact, the Australian Bureau of Statistics has stopped providing a trend estimate because it cannot identify what has been spent due to the one-off stimulus measures. We will need a couple of quarters of 1-plus per cent growth and a stronger employment market before we see any rate hikes and, in our view, February 2010 is the earliest possible date for a rise.

As mentioned earlier, reporting season was largely positive, and in particular healthcare stocks reported strong results, which saw the sector outperform the market in August for the first time since the market rally began in March 2009. It appears the regulatory overhang on the sector is dissipating, but foreign exchange (FX) headwinds will remain an issue for the current fiscal year.

However, the underlying earnings-per-share (EPS) growth will be strong for the sector, which will more than offset the adverse currency impact. Assuming there are no violent moves in the FX markets from this point on, the sector should deliver pleasing numbers this year and beyond.

It is worth keeping in mind that healthcare companies are over-represented in the handful of stocks in the market where earnings and, more importantly, EPS grew in the 2009 fiscal year and are projected to do so again in 2010 and 2011. Yet the sector is trading the cheapest it has done compared to the market in seven years. This is an opportunity we believe won't be repeated very often and investors should position themselves to take full advantage of it. The catalyst for the sector's re-rating could be a break in the Australian dollar, which may coincide with a return of a mild dose of risk aversion. Investors would then seek the safety of this sector's earnings and under this scenario the FX headwinds would certainly ease considerably.

Healthcare currently represents our second largest active bet at 10 per cent of the portfolio, and all four major healthcare companies produced high-quality results.

In the industrial sector, most companies will have lower earnings in the December half compared to the six months to June; in other words things are still tough out there and profits will not rise until the June 2010 half at the earliest. Large companies and banks are squeezing smaller companies – trading terms have changed for smaller players and every company that has some market power is using it to its fullest extent.

The retail sector remains an interesting story. Interest in the sector is beginning to intensify with the forthcoming public listing of Myer. The sector has had a tremendous run from the market low, with the share prices of JB Hi-Fi and David Jones each increasing by about 260 per cent. This is testimony to the resilience of the consumer and strong financial position of these companies.

Recent strong consumer sentiment figures also point to the probability that the retail sector will continue to exhibit reasonable growth. We anticipate the Myer initial public offering will be well subscribed, even though it is likely to be priced at a full valuation.

This will only further support the investment proposition of existing listed retailers David Jones and JB Hi-Fi. The David Jones annual result is due on 24 September and it will be interesting to see if the company upgrades its sales and earnings guidance. «

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