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Sharemarket earnings & valuations post reporting season

Key points

- While profits for Australian listed companies fell over the last year, the profit reporting season just ended has been better than expected. This has been the case globally and share analysts' earnings expectations are now being revised up.
- While shares are no longer dirt cheap following the rebound from March, they are not expensive either.
- Notwithstanding inevitable corrections, further gains are likely as the earnings outlook continues to improve.

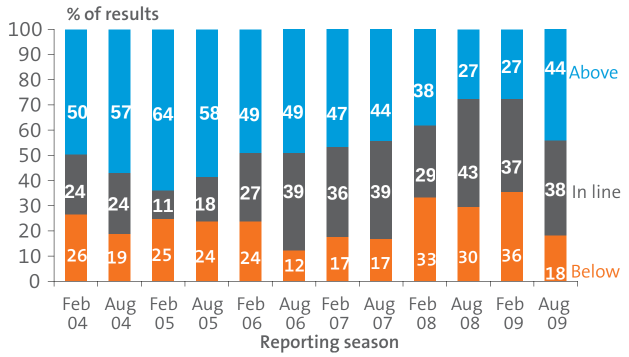
Introduction

Shares have risen sharply from their lows in March. Global and Australian shares are up by around 45%. This naturally has some concerned that shares are now expensive. Our assessment is, firstly, that shares are still not expensive and, secondly, that future gains will be further underpinned by an improvement in the profit outlook. However, first let's take a look at the profit reporting season just ended.

Reporting season for Australian shares

While Australian 2008-09 profits are down around 18% making it the biggest slump since 1990-91, it has not been the disaster that had been feared. In fact, **the profit reporting season overall has been pretty positive**. Firstly, positive surprises have dominated making it the best season for results relative to expectations in two years. 44% of results have come in better than expected compared to only 18% below. This is a big improvement on the last two reporting seasons when there were more companies surprising on the downside than the upside. In fact, the net balance of positive less negative surprises of +26% is the best it has been since the August reporting season two years ago. See the next chart.

Profit results relative to market expectations



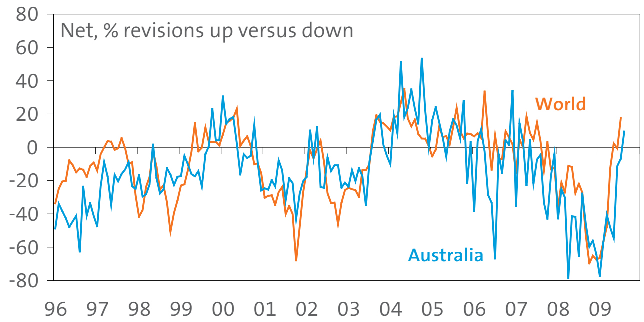
Source: AMP Capital Investors

Secondly, company outlook statements have been far more positive than was the case in the last two reporting seasons. While companies remain somewhat cautious, positive outlook comments have dominated negative comments by a ratio of nearly four to one. Whereas, in the last two reporting seasons negative comments dominated.

Strong margins have been another key theme thanks to cost control and the economy holding up better than feared six months ago, dividends being cut but not by as much as expected and continued capital raisings in order to reduce gearing and (possibly) fund takeovers. By sector, the key areas of upside surprise were in energy, retailing and capital goods and the key areas of downside surprise were in real estate, transportation and telcos.

As a result of better than expected results and more favourable outlook statements, equity analysts' earnings expectations for the 2009-10 financial year have been upgraded by around 3%, signalling the likely start of an earnings upgrade cycle after two years of downgrades. The next chart shows that the number of companies seeing their earnings being revised up by analysts for the year ahead now outweighs the number of companies seeing downgrades. This follows two years of net downwards revisions. It's the same picture globally after better than expected earnings reporting seasons in most countries.

Share analysts' revisions to earnings forecast are now turning positive



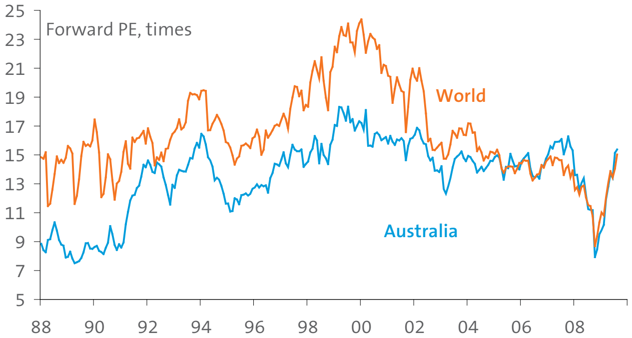
Source: Thomson Financial, AMP Capital Investors

With companies having reduced costs and economic recovery pointing to stronger revenues going forward it's likely that further upwards revisions to earnings expectations lie ahead. This is favourable for shares.

Are shares now expensive?

There are numerous ways to measure sharemarket valuations. The simplest way to is to compare the level of share prices to earnings and a common approach along these lines is to use the consensus of equity analysts' earnings expectations for the year ahead. This is usually called the forward price to earnings (PE) ratio as earnings are for one year forward. On this basis, global and Australian shares have risen from forward PEs of eight or nine times, which was historically low, to now around 15 times which is in line with long term averages. See the next chart.

Price to earnings ratios have increased but are not excessive

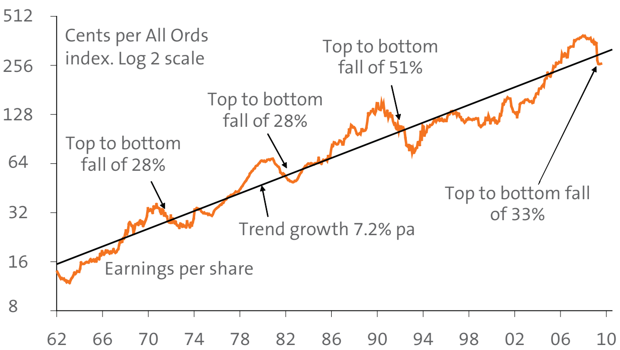


Source: Thomson Financial, AMP Capital Investors

This would suggest that while shares are no longer cheap they are not expensive either. However, it is worth noting that year ahead earnings estimates (while being revised up) are still depressed after their recent slump, particularly for sectors like resources and banks. As a result, the price to earnings ratio is probably being overstated.

One way to adjust for the cyclical volatility in earnings is to use trend earnings. Taking Australian shares, the chart below shows nominal earnings per share for the Australian All Ords index against its long-term trend. Long-term trend growth in Australian company earnings is around 7% per annum. Following the slump in earnings over the last two years, earnings are now below their long-term trend. Taking trend earnings (currently 310 cents per share) as a guide to the central tendency for earnings and applying a PE multiple of 15 times (the long-term average) would suggest that fair value for the All Ords index is now around 4650, which compares to the current level of 4500 and suggests that shares are still somewhat cheap.

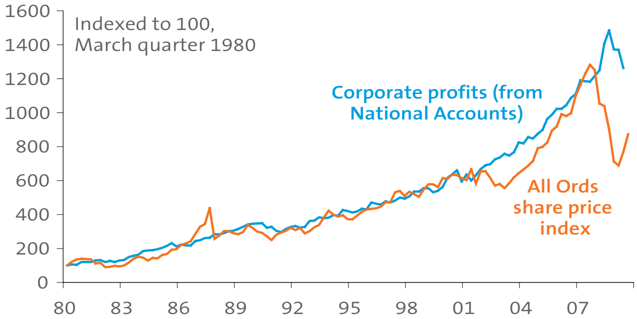
Australian earnings per share



Source: Global Financial Data, Thomson Financial, AMP Capital Investors

Another useful approach is to compare the level of share prices to the level of profits reported to the tax office, which the Australian Bureau of Statistics reports each quarter. This measure of profits relates to profits produced in Australia and relates to operating profits and so ignores changes in asset values and offshore sourced earnings. The next chart below shows that over time the Australian share market moves roughly in line with this measure of operating profits.

Australian shares remain well below the level suggested by profits



Source: Bloomberg, Thomson Financial, AMP Capital Investors

Right now though shares are well below the level suggested by company profits. While the share market rightly anticipated the slump in profits, the 55% top to bottom fall in the share market has been disproportionately large compared to the 15% fall in this measure of profits. Even after the rebound in the share market since March, profits would need to fall another 30% to justify shares at current levels. With signs the economy is stabilising and the outlook for profits is improving this seems unlikely.

Finally, it should be noted that our analysis has made no allowance for the fact the earnings yield and dividend yield on shares is now running well above the yields available on cash and bonds, providing another indication that shares are not expensive. The bottom line is that while the rally in shares means shares are no longer dirt cheap, they are not expensive either and most valuation measures suggest there is still more upside left.

Cyclical bull market with much further to run

While valuation is no guide to the short-term direction for shares. The macro-economic or cyclical backdrop is far more important in the short term. Last year the macro backdrop was terrible, but now it's very favourable. Economic and profit recovery is coming into view at the same time that inflation and interest rates are low and there is lots of cash sitting on the sidelines in low yielding assets. The average cyclical bull market in Australian shares in the post war period has lasted four years and seen gains of 132%[1]. But so far we have only seen a fraction of this – Australian shares having now rallied only 45% from their March lows over nearly six months. History suggests that the time to really start worrying again will be when economic overheating returns, inflation becomes a problem and interest rates rise to onerous levels – all of which seems a fair way off.

Concluding comments

After 45% gains from March lows and with the seasonally difficult September/October period now upon us shares are at risk of a short term pause or correction sooner or later. However, valuations are still a long way from being onerous and the cyclical backdrop is favourable, suggesting that the broad trend for shares will remain up.

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[1] The favourable cyclical backdrop for shares is discussed in detail in "From bear to bull - the cyclical upswing in shares", Oliver's Insights, July 2009

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