Reporting season won't define market direction

Strategy

ST Wong

Investors are asking whether this reporting season will make or break the extraordinary market rally that started in late March. This August holds a greater degree of importance compared to previous years – the visibility of companies' earnings outlook has deteriorated and, with it, the dispersion of market estimates has widened considerably.

Compounding this scenario is an uncertain macroeconomic environment buffeted by a stop-start recovery.

The first half of 2020 has been unexpected, to say the least. Outlook scenarios turned obsolete quickly with the rapid spread of COVID-19, evolving public and health policies and a nascent new business cycle emerging from the economic trough. Some economy-sensitive segments of the market have begun to participate in the initial rebound but others are struggling to recover. It's hard to hang a hat on which sectors or companies will ultimately seize leadership as the recovery takes hold.

Compared to previous years, financial guidance from companies will be less forthcoming, leading to large dispersions in analysts' estimates for the 2021 financial year. Cash flow will be distorted by provisions for bad debts, inventory and working capital build-ups. Against this backdrop, companies that demonstrate visibility in earnings growth, strong cash flow conversion, robust balance sheets and management adaptability to change will be bid up.

In the near term, there are several trends that are worth highlighting.

■ **Stay at home:** E-commerce has exploded on the back of stay-at-home requirements and fiscal stimulus. Online stores such as Kogan and Temple & Webster have clearly benefited. Some traditional retailers have been able to adapt, including JB Hi-Fi, Accent Group, Beacon Lighting and Adairs. Enablers of the transition to online such as data centre operators NextDC and Macquarie Telecom have also seen demand soar. Finally, sustained demand for at-home dining will likely prolong the unprecedented demand for supermarket goods.

■ **Reopening:** Investors will question the sustainability of stay-at-home trends as the economy reopens. However, reopening trends are uneven due to renewed efforts to curb the spread of COVID-19 in states where cases have surged. This makes the longevity of stay-at-home trends difficult to predict. Offshore experience clearly indicates stay-at-home demand will decelerate as pent-up demand fades and supply issues are ironed out as reopening kicks in.

■ **Sectors struggling to recover:** Challenges continue to confront transport, tourism and media stocks as regional resurgences of COVID-19 keep demand trends uncertain. Any share price rerating for these sectors will depend on the length of hibernation affecting operating outlooks and, in the case of toll roads and airports, the prospect of dividends resumption.

■ **Management adaptability:** Companies such as Alliance Aviation, City Chic and Perpetual have taken the opportunity to improve their market positions through acquisitions. This trend will continue to feature prominently as the management of a number of Australian companies turn opportunistic. In other cases, we expect companies to lean on self-help strategies through cost-containment plans to help them through a softer demand environment.

It's hard to hang a hat on which sectors ... will ultimately seize leadership.

The August reporting season will not offer a silver bullet to the question of market direction. Let's be clear: it's a challenge to conceive a six- to 12-month outlook in the middle of a global pandemic when part of the answer will depend on evolving public and health policies.

As a base-case, we expect the nascent economic recovery to continue in the second half of 2020. The recovery will be slow and uneven but will be assisted by additional fiscal and monetary support. However, views can shift meaningfully and quickly around a variety of factors affecting the macro environment – in particular, a meaningful change in the health outlook for COVID-19 that leads to a return to the normalisation of consumer behaviour offers the greatest upside to markets.

In such a volatile market, and where liquidity may be amplified both up and down, it's important to be disciplined about what you want to own, the price you want to pay for it and what you think it's going to be worth in two or three years. ■

ST Wong is the chief investment officer of Prime Value Asset Management.

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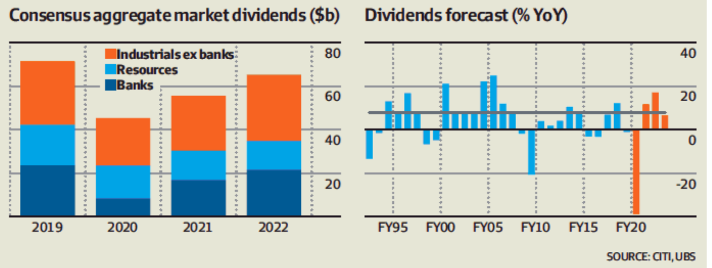

SOURCE: CITI, UBS

DIVIDEND RIVER IS FAR FROM DRY

Equities Distributions are expected to be harder to come by this year but many companies will still pay up, writes **William McInnes**.

The Australian sharemarket is set to face one of its worst earnings seasons on record, with earnings forecast to fall 28 per cent in August.

Consensus forecasts are for dividends to fall across the market by 39 per cent in the 2020 financial year, worse than the 20 per cent drop during the global financial crisis.

Many companies have scrapped or heavily reduced their dividends but the doom and gloom felt by some investors may be overdone, as many of the blue-chip stocks are still poised to return profits to shareholders.

"There are a range of companies that won't be paying dividends that probably could, but it's not a flat-out fact that there are no dividends outside the iron ore miners," says Atlas Funds Management chief investment officer Hugh Dive.

"In the wider market, the miners are obviously doing quite well and, while the banks are quite opaque, there's no reason why the healthcare sector won't pay dividends."

UBS forecasts that 30 of the companies it covers will maintain or increase their June-half dividends per share during the August reporting season.

Defensive stocks such as Brambles, Aurizon, Telstra and Chorus are likely to at least maintain their payouts from last year through their resilient earnings.

Surging iron ore and gold prices have meant many of the miners are flush with cash at a time when others aren't, pleasing shareholders chasing strong returns.

UBS is tipping Fortescue Metals Group, Evolution Mining, Northern Star Resources, Newcrest Mining, Regis Resources, Iluka Resources and OZ Minerals as the most likely to maintain or increase their dividends per share through the August reporting season.

Last week, Rio Tinto gave investors a taste of what was to come, paying an interim dividend of $US1.55 a share, 3 per cent above the ordinary dividend it paid last year.

Even the big banks could prove to be fertile ground for dividend-seeking investors. While their dividends may be reduced, the big four will probably be under enough pressure from their retail shareholders to continue to pay a distribution.

"There is some awareness that the likes of Commonwealth Bank have 800,000 retail shareholders and a lot of them are self-funded retirees that are relying on those dividends," Dive says.

"If Commonwealth Bank pays nothing, it will be interpreted quite poorly."

Last week, the Australian Prudential Regulation Authority updated its guidance, asking banks to cap, rather than defer, their dividends as they continued to maintain caution and make the most of capital buffers as needed.

"APRA's latest guidance is somewhat of a relief for retirees who rely on bank dividends to make ends meet," Plato Investment Management managing director Don Hamson says.

"In its previous statement in April, APRA discouraged banks and insurers from paying dividends, causing ANZ, Bank of Queensland and Westpac to defer their interim dividends, with NAB cutting its dividend by 64 per cent."

JPMorgan says the revised guidance means banks that deferred dividends in the first half of the year are now in a position to pay up.

"APRA's clarification of its dividend guidance earlier in the week leads us to believe that ANZ, Westpac and Bank of Queensland are now able to declare first-half dividends," JPMorgan analyst Andrew Triggs says.

"At this stage we assume ANZ and Westpac do not pay a deferred dividend, but there is capacity for a modest dividend should the board be happy to run into buffers."

The banks will still probably be under some pressure to make sure they don't eat too much into their balance sheets, however, as the second wave of COVID-19 and associated restrictions in Victoria are creating significant economic uncertainty.

"You don't want a situation where you're paying a dividend then asking for capital a couple of months later, like we saw with NAB earlier this year where they paid a dividend and raised capital on the same day," says Dive.

Several other companies have profited despite the economic fallout from the COVID-19 pandemic and will probably maintain their dividend payouts.

JB Hi-Fi and Harvey Norman benefited from a wave of sales as businesses were forced to accommodate staff working from home, and Wesfarmers' retail divisions increased sales through the first half of the year. Domino's Pizza is also likely to maintain its dividend, as government-imposed restrictions have increased takeaways.

The heightened economic uncertainty as Victoria enters stage four restrictions poses an ever present risk to dividends, however. Companies are likely to tread cautiously this earnings season, even if they are in a position to pay a dividend.

"There's going to be a lot of reasons not to pay dividends and a lot of reasons to preserve cash," says Dive. ■

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Hugh Dive, pictured, Atlas Funds Management chief investment officer