

Australia Equity Strategy

After Little Surprise In Reporting, What's Next For The Market?

■ Equities

- **Can defensive stocks keep going?** — In the end there wasn't much unexpected from results overall, with the minimal earnings growth for the market and patchy outcomes across sectors similar to how it's been for a while. But that justified the cautious sentiment that has driven the strong move into defensive and high yielding stocks in the past year, with their re-rating generating significant outperformance. The question now is whether they can keep going with less scope to re-rate.
- **Are growth prospects evolving?** — If conditions remain difficult in more cyclical sectors, recent trends could continue, but there does seem scope for improvement in some areas. The ECB's latest initiative should contain some of the tail risks to markets and growth that may have developed, and in China the efforts to stabilize growth have the potential to show more success in coming months. After the recent plunge in bulk commodity prices, prospects could improve a bit for resource stocks.
- **Is anything changing at home?** — The timing remains uncertain, but there's more of a sense of the resource cycle maturing and of the eventual transition back to more domestic growth in Australia. This should enable a recovery in housing, which may already be in its initial stages, and should benefit stocks involved; and it could see more easing in financial conditions in time, perhaps through the currency, which would lift earnings from overseas. So there should be growth in more sectors again.

Tony Brennan

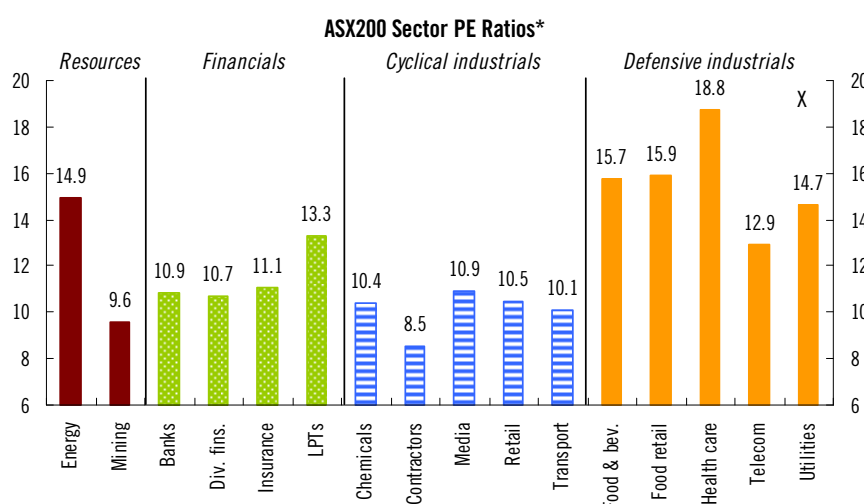
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Figure 1. The strong push into defensive stocks has left them trading on premium multiples



* On one year forward IBES consensus earnings estimates. Source: IBES, Datastream, Citi Research

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Figure 2. Recommended portfolio

Stock	P'folio Wgt%	Index Wgt%	Industry	P'folio Wgt%	Index Wgt%	Sector	P'folio Wgt%	Index Wgt%
Santos Ltd	4.5	1.1	Energy	9.0	6.8	Energy	9.0	6.8
Origin Energy	4.5	1.2						
BHP Billiton Limited	13.0	9.7	Mining	22.0	16.9	Basic Materials	28.5	20.5
Rio Tinto Limited	6.0	2.1						
Fortescue Metals Grp	3.0	0.5						
			Steel	0.0	0.3			
			Building Materials	0.0	0.8			
Orica Limited	3.0	0.8	Chemicals	3.0	1.5			
Ancor Limited	3.5	0.9	Paper & Packaging	3.5	0.9			
			Transport	0.0	1.7	Industrials	5.5	6.3
			Infrastructure	0.0	2.6			
Boart Longyear	2.0	0.1	Contractors	5.5	1.2			
Lend Lease Group	3.5	0.4						
			Other Industrials	0.0	0.8			
Crown Limited	3.0	0.4	Leisure - Gaming	3.0	1.4	Cons. Discretionary	5.0	3.7
Seek Limited	2.0	0.2	Media	2.0	1.3			
			Consumer Apparel	0.0	0.2			
			Retailing - Non-food	0.0	0.8			
Woolworths Limited	4.0	3.6	Retailing - Food	4.0	7.9	Consumer Staples	4.0	9.1
			Food & Beverages	0.0	1.3			
ResMed Inc.	4.0	0.3	Health Care	4.0	4.3	Health Care	4.0	4.3
ANZ Banking Grp Ltd	13.0	6.3	Banks	25.0	27.7	Financials	44.0	42.1
Commonwealth Bank.	12.0	8.4						
Suncorp-Metway	4.0	1.1	General Insurance	8.0	3.4			
Insurance Aus Group	4.0	0.8						
AMP	3.5	1.2	Wealth Managers	3.5	1.4			
Stockland	4.0	0.7	Property	4.0	7.7			
ASX Limited	3.5	0.5	Diversified Financials	3.5	1.8			
			Info. Technology	0.0	0.7	Info. Technology	0.0	0.7
			Telecom	0.0	4.8	Telecom	0.0	4.8
			Utilities	0.0	1.9	Utilities	0.0	1.9
	100.0			100.0	100.0		100.0	100.0

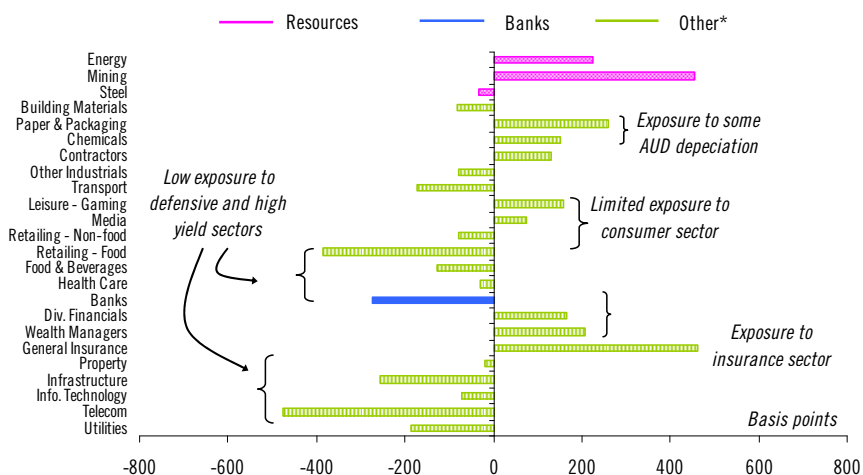
Source: IRESS, Citi Research

Our portfolio strategy favours some areas with recent growth and others with emerging growth

In our strategy we've kept an overweight position in resources, finding it hard to recommend changing after bulk prices look to have overshot; and also stayed overweight insurance, while moving to overweight in residential property trusts, and adding stocks with overseas earnings.

Overweight resources, other materials, insurance, residential property trusts

Figure 3. Recommended portfolio industry weightings relative to index weightings

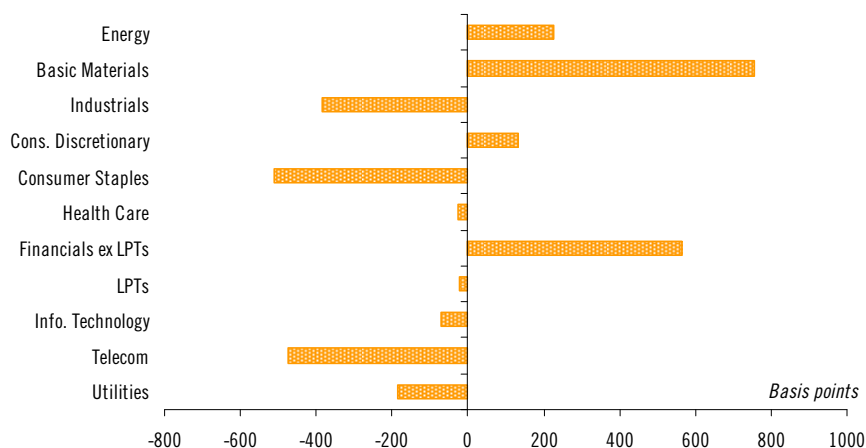


* Market ex resources and banks. Source: IRESS, Citi Research

Meanwhile, we've stayed underweight areas like telecoms and utilities, and lowered food retailing to underweight and health care to market weight, while staying slightly underweight banks; in the process, we've removed WES, CSL, UGL, NAB and added SGP, CWN, LLC, CBA.

Underweight telecoms, utilities, infrastructure, food retailing

Figure 4. Recommended portfolio sector weightings relative to index weightings



Source: IRESS, Citi Research

Portfolio Strategy

FY12 earnings were largely as expected

The reporting season turned out generally to provide not too much of a surprise overall, and the market performed fairly well throughout. The outcomes for FY12 were broadly in line with expectations in aggregate; and while there were considerable downgrades to FY13 forecasts, in part due to the fall in iron-ore and coal prices, this seemed no worse overall than the risk the market had allowed for in low valuations. The reporting season was thus considered reasonably good under the circumstances.

FY13 downgraded weren't more than the risk allowed for

Across the market there weren't that many unexpected developments. A core of the larger stocks outside of resources delivered moderate but steady growth, generally from being in more defensive industries – food retailing, telecoms, utilities – and aided in individual case by business turnarounds (WES), government support (TLS), or a subdued but consistent backdrop (the banks). Stocks in a couple of mid-size sectors fulfilled higher expectations by reporting strong growth, namely in health care and insurance.

In contrast, the mining stocks experienced large declines in earnings and scaled back expansion plans, which reverberated across the mining contractors and construction groups. The energy companies also provided mixed news, compared to high growth aspirations for the sector. Meanwhile, financial stocks outside of banking and insurance continued to struggle, with capital markets and investor activity as moribund as it's been. And consumer stocks dependent on more discretionary spending, in the retail and media sector specifically, continued to confirm very difficult operating conditions.

The market has performed well but may need to consolidate

But as noted, most of this wasn't news to the market, it confirmed existing trends. We have some more quantitative analysis of the results in the third part of this report (pages 23-27). However, naturally of more importance now is what to expect in the market over the coming 12 to 18 months. One observation to make is that, having held up in the face of the downgrades to earnings forecasts, the market is now trading a bit more firmly against prospective earnings. The market PE is back to its average since the GFC, around 12½x one year ahead earnings, and while this isn't high historically, in this more cautious climate it may constrain the market a bit in the near-term (see figure 7, page 9). Our forecasts for the ASX200 remain 4450 by end CY2012 and 4750 by mid CY2013 (from 4326 currently).

Can the more defensive sectors continue to outperform?

Defensive sectors have rallied strongly, but it seems hard for that to continue

The results may not have been a surprise, but as such they confirmed the assessment of many investors in the past year, that earnings growth would be hard to come by, and that modest growth and a good yield would be attractive. That encouraged the large push into defensive and high yield stocks, which in the end drove the re-rating that underpinned their performance, generally far more than their growth and yield did alone (figures 11-14, pages 11-12).

The question is whether it will continue to be the right strategy. The earnings growth prospects in the market would seem as patchy and uncertain as a year ago, with some of the influences on conditions similar to how they've been. The difference is that the defensive areas have rallied so strongly, that they're trading at an even larger premium to the rest of the market; PE multiples are mostly much higher (figures 11-13, pages 11-12), and yields have come down to be similar to other areas (figures 15-16, page 13). Our global strategy team has also recently noted this across other markets, in their report "[Historic Yield Crossover](#)", 29 August 2012.

Growth prospects seem to be evolving elsewhere

Given the limited prospects of further re-rating, that just leaves the earnings growth of the defensive stocks, which has been steady, but mostly only moderate. And it also comes down to growth elsewhere which, if negative again in a number of sectors, would make the defensive growth relatively stronger. Essentially, it comes down to whether there's much prospect of growth being delivered elsewhere, whether the existing trends persist or change in some areas. We are inclined to think the latter, and so don't see the potential from here in defensive sectors.

Can there be better growth in less defensive sectors?

It seems the case that conditions across the market aren't changing quickly, but there do seem some areas of potential change. The most significant of these is the resource sector, given its scale, and partly due to the rapid drop in bulk prices in the past month. It's hard to think iron-ore and coal prices haven't overshot and are due a rebound. It seems that a confluence of a drop in demand, exacerbated by an inventory correction in the steel industry, and a lift in supply after better weather in the producing countries, have combined to cause a large market imbalance in the short-term. But with prices now considered insufficient to balance the market in normal conditions, some rebound seems probable (figures 19-22, pages 16-17), as argued by our resource analysts in their report, "[Tipping Point](#)", 2 September.

China's growth has slowed, but should remain solid

Of course, the larger picture is slower growth in China, and it's getting harder to argue this is purely cyclical, and not an intention to grow more sustainably over time (figure 22, page 17). But there seems little evidence at the moment to suggest the aim is much less than 7-8% GDP growth, in the next few years at least, which should still provide decent support for material prices. Despite the doubts, it still seems reasonable to us to expect the trend to be a fairly gradual decline in material prices over coming years, given the further urbanization and development China is likely to undergo. It's anticipated by our economists that efforts to stabilize and even mildly strengthen growth will meet with some success in coming months, and combined with the potential for a technical rebound in iron-ore and coal prices, this suggests scope for a slight turnaround in the fortunes of the resource sector.

Nevertheless, the reality has dawned that China can't grow at breakneck speed forever, and resource capex plans are getting scaled back. And this could herald the beginning of the transition in the Australian economy away from the resource growth that is dominating these present years, back to broader growth across the domestic economy, which should open up other areas of earnings growth in the market.

Are domestic sectors moving into some growth again?

Resources investment is expected to peak this year

There's general acceptance that the divergent growth within the Australian economy in recent years has hurt the earnings in a number of market sectors – building materials, retailing, media, transport etc. In time, one would expect things to improve as the "two-speed" economy passes; however, obviously the timing here is critical, whether the transition is beginning soon or some years off still.

Existing forecasts from official circles and our analysts seem to envisage annual resource capex growth peaking this year, in FY13, and most recent capex deferrals don't appear to have altered this, with existing projects underpinning the pipeline. That points to capex growth quarter to quarter peaking perhaps 12-18 months from now, though possibly sooner if we see more delays on near-term projects.

As this happens, to maintain the economy's growth and keep unemployment low, the roughly 80-85% of the economy outside of the resource and related sectors will be required to take up the slack, and other types of investment, including residential and non-residential building, will need to pick up. This could well require easier financial conditions, possibly further lowering of interest rates at some point (though our economists are not expecting this), and some depreciation of the exchange rate, which would seem a natural response to the maturing commodity cycle. We have written about this in our report entitled "[Where Is The Earnings Growth As The Resource Cycle Matures?](#)", 29 August 2012 (see also figures 24-27, pages 19-20)

**Growth in areas outside resources
should pick-up**

The feeling until recently has been that this transition is some way off, a year or two at least, but recent developments, with the capex deferrals and the drop in bulk prices, suggest it could be happening sooner. Moreover, our economists have argued recently that the housing market seems to be starting to pick up already, after the interest rate cuts that have occurred, in their report "[The Cycle Turns in Housing](#)", 8 August 2012. We know markets tend to anticipate developments and can adjust earlier, and that needs to be considered as well. Indeed, the Australian dollar has held up surprisingly well in the past month, and the falls in bulk prices, even if they are reversed somewhat, could perhaps precipitate the start of some depreciation of the currency.

At least, it seems at some stage that over the next year or two, weak parts of the economy will probably be recovering, like housing, and possibly other types of building; and there should be some support to sectors like retailing and transport. If the exchange rate is also depreciating, other sectors including tourism and manufacturing should also benefit, and companies operating overseas will have their earnings lifted in Australian dollars.

**A recovery in housing may have already
started**

This suggests an improvement in earnings growth in a number of sectors of the market, but it still comes down to timing. One way to respond might be to take on some exposure to these trends, perhaps in a conservative way, and to enhance positions over time to the degree warranted. Our suggestion at this stage is to consider the residential property trusts, which also offer reasonable yields, and a few companies with significant operation overseas, which can get some benefit from a decline in currency. In the near-term, we would still be cautious about building materials, retailing and transport, but keep an open mind.

What about any other growth areas?

Beyond these broader macro forces and the sectors they affect, there are some remaining sectors to note. The stocks in the healthcare and insurance sectors seem to us generally capable of continuing to generate the growth they have done for a while longer, but we find valuations in health care very full, while not necessarily so yet in insurance (figures 28-29, page 21). For other financial stocks, it's hard to see capital markets and investor sentiment improving greatly at the moment, but it needs to be watched. And as mentioned, in sectors like retailing and media, where major structural change is occurring, we would also be cautious.

So to sum up, our sense is that there is less to be gained from here in defensive stocks, and we are recommending underweight portfolio positions now in food retailing, food and beverage manufacturing, telecoms, utilities, infrastructure and a neutral position in healthcare. We're also still advocating underweight positions in struggling sectors like general retailing and building materials. Balancing this, we're suggesting overweight positions in resources; insurance; residential REITs; chemicals, packaging and construction (partly because of currency exposure); and a broadly neutral position in other financial sectors, aggregating banks and diversified stocks (figures 2-4, pages 2-3).

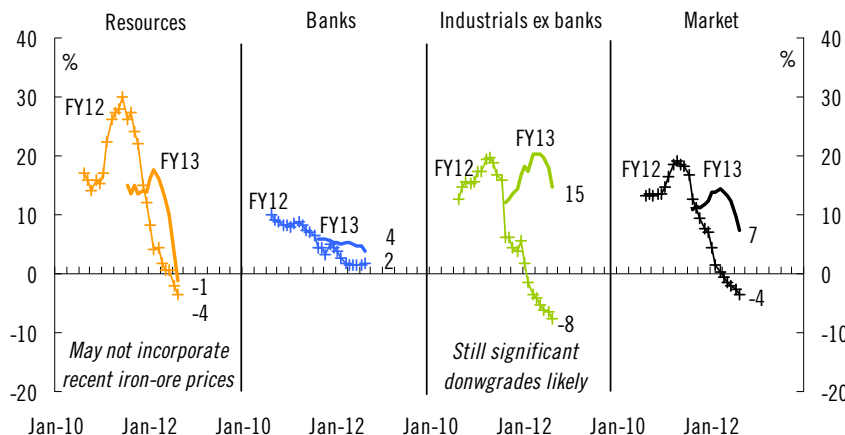
The Post Reporting Picture

The Australian market now seems to face another year of at best little earnings growth

As tends to be the case with the obligation on companies for continuous disclosure, FY12 earnings in aggregate came in close to expectations in the reporting season, but FY13 earnings were downgraded considerably, and estimates still don't look to have fully adjusted.

FY13 earnings estimates have been cut significantly

Figure 5. Consensus ASX200 EPS growth revisions

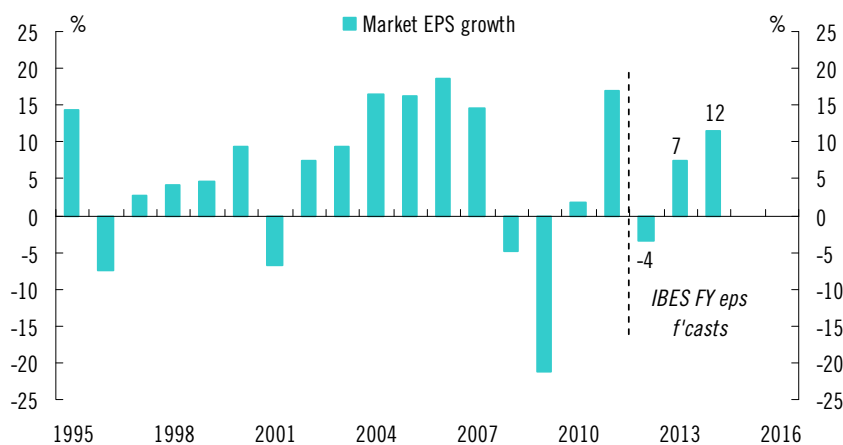


Source: IBES, Datastream, Citi Research

Citi numbers based on our analysts' estimates, which factor in the decline in bulk prices, have FY13 earnings in aggregate growing at 4%, and with industrial ex banks growth looking high still, further downgrades could see market earnings falling moderately for a second year.

There seems risk of further downgrades

Figure 6. ASX200 EPS growth



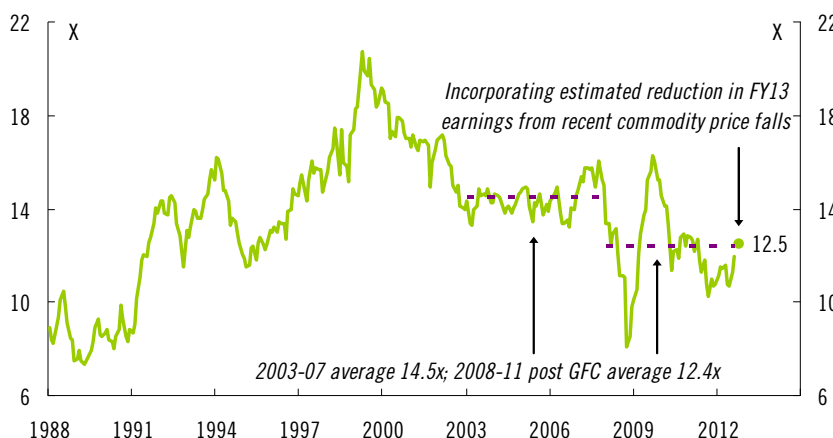
Source: IBES, Datastream, Citi Research

The market has held up fairly well given the downgrades and may need to consolidate a bit

The surprise aspect of the reporting season to many was that the market didn't weaken more, but it showed that downside risk to earnings forecasts was already allowed for in modest valuations, and the market is now a bit more firmly valuing the newly downgraded earnings.

The market appears more firmly valued

Figure 7. ASX200 PE ratio on one year forward IBES consensus earnings estimates

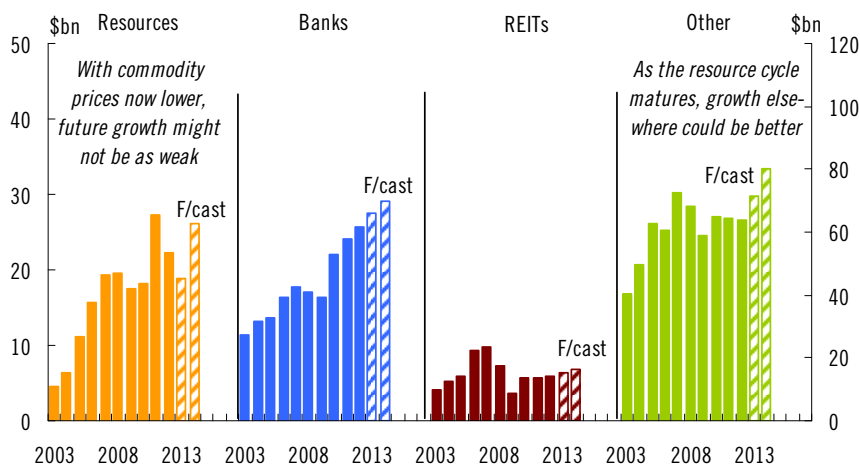


Source: IBES, Datastream, Citi Research

The market PE multiple is now close to its average since the GFC, which is still not high historically, but it may constrain the market initially given the greater caution these days; yet the higher PE might still be sustainable if better earnings growth is possible beyond FY13.

There market may consolidate in the near-term

Figure 8. Net Profit After Tax by major sector*



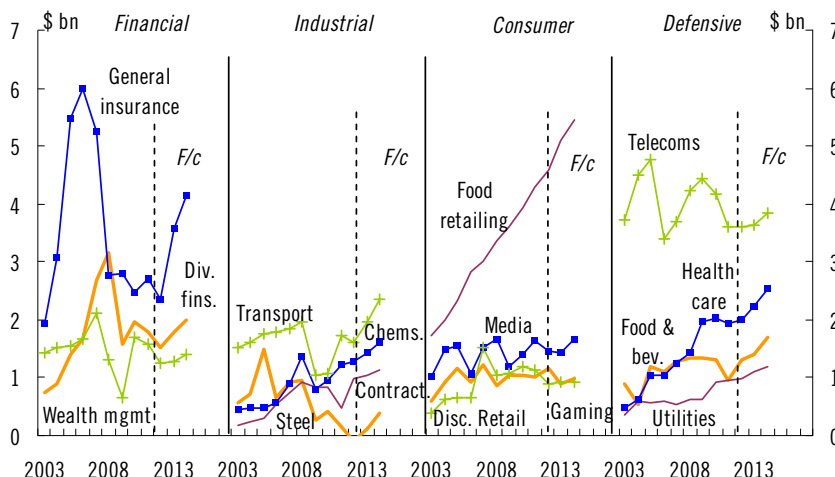
* Forecasts are Citi analysts' bottom-up estimates. REITs also include infrastructure stocks. "Other" are commonly referred to as industrials (ex banks). Source: Datacentral, Reuters, IBES, Citi Research

There are still a number of sectors generating earnings growth, even with others more doubtful

As well as for the banks, there is good earnings growth forecast for other sectors outside resources, in areas where it seems fairly probable like insurance, food retailing and healthcare, even if it's more doubtful in other sectors tied to the domestic economy or financial markets.

Growth prospects remain firm in some industrial sectors

Figure 9. Net Profit After Tax by "Industrial (ex banks)" subsectors*

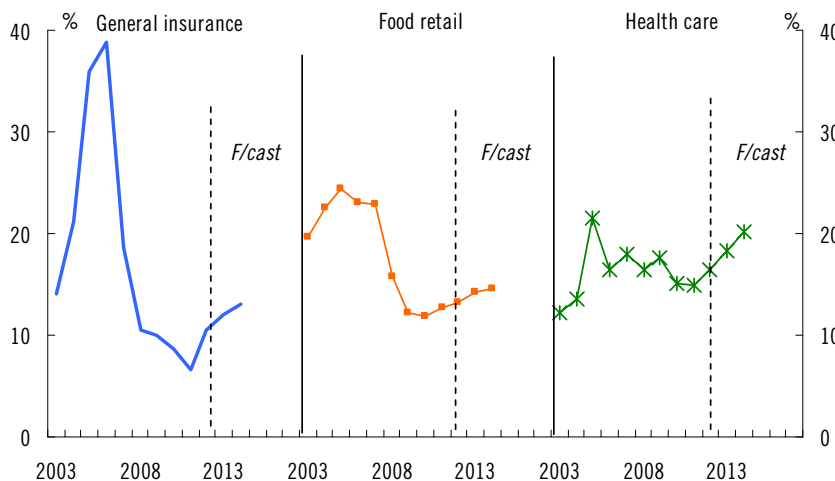


* Forecasts are Citi analysts' bottom-up estimates, except for Transport and Steel, which are IBES estimates. Sub sectors of other in Figure 8. Source: Datacentral, Reuters, IBES, Citi Research

Though figure 9 is a bit busy, we find taking stock of the level of sector earnings gives some idea of the potential for growth, as do sector ROEs, which for these mid size sectors, reinforce the potential for growth in insurance and food retailing, while suggesting risk with health care.

Insurance, food retailing and healthcare earnings could keep growing solidly

Figure 10. Return on Equity*



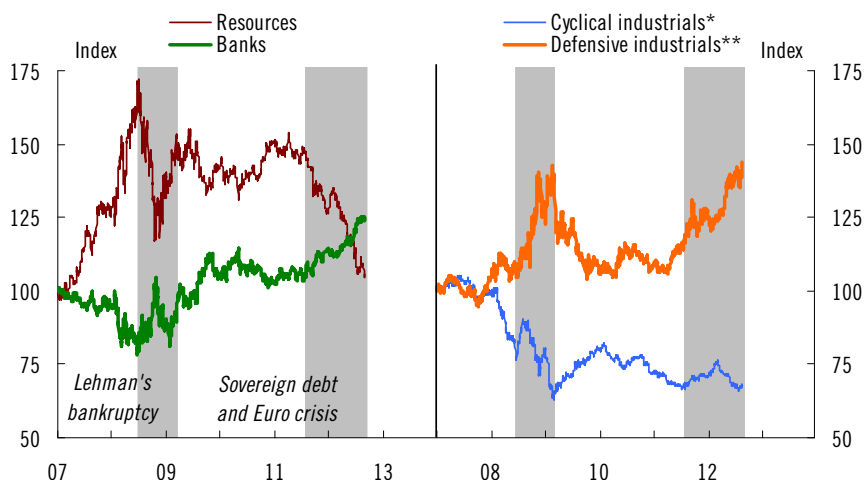
* Estimates are bottom-up Citi analyst forecasts. Source: Datacentral, Reuters, Citi Research

The market is paying an increasing premium for the stocks considered to have reliable growth

Clearly, to have good prospects of decent growth is one thing, while the amount being paid for it is another; and as has been evident over the past year, investors have moved more and more into safer, defensive areas of the market as earnings have disappointed more broadly.

Defensive sectors have rallied strongly

Figure 11. Major sector relative performance (total return basis)

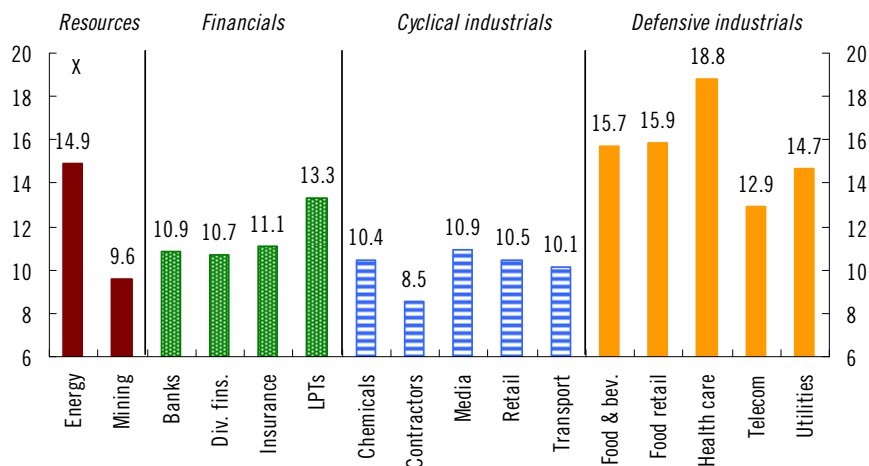


* Cyclical include discretionary retailing, media, transport, contractors. ** Defensives include healthcare, food retailing, food & beverage mfg, telecoms, utilities. Source: Datastream, Citi Research

The reliability of earnings and the strong push by investors have driven the substantial out-performance of defensive stocks, and it has been the right strategy to have; but it has now taken valuations of defensive stocks to a very large premium over the rest of the market.

Defensives trade at a large premium

Figure 12. ASX200 sector PE ratios*



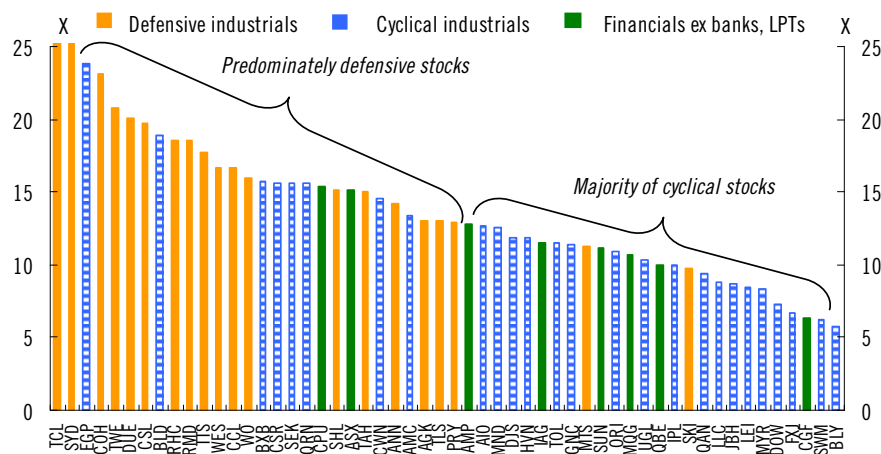
* On one year forward IBES earnings estimates. Source: IBES, Datastream, Citi Research

It's not clear to us that all the growth is reliable, or that cheaper growth can't be found elsewhere

The premium on reliability has polarized valuations, with defensive stocks predominating among those with high multiples, along with just those cyclical stocks that are possible takeover targets or have solid secular growth, with all other cyclical stocks on lower multiples.

Most cyclical stocks are on lower multiples

Figure 13. PE ratios on FY13 IBES consensus earnings estimates*

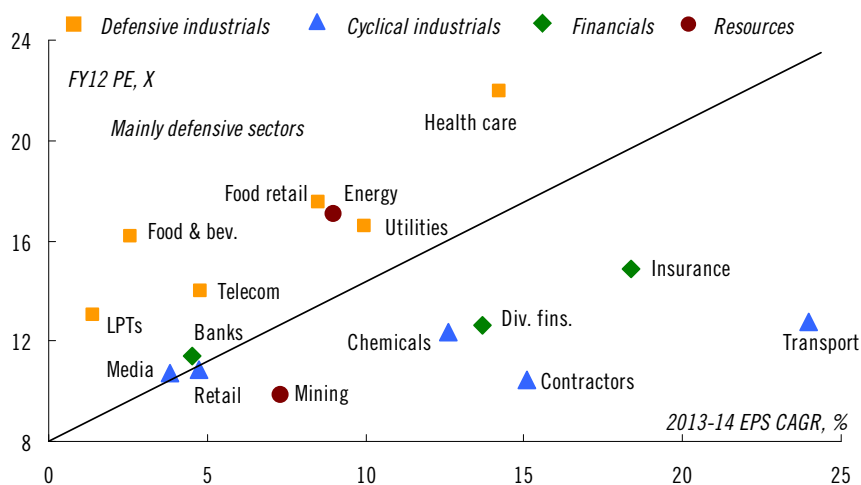


* ASX50 stocks excluding banks, LPTs and resources. Source: IBES, Datacentral, Citi Research

Yet when valuations are contrasted with forecast growth, for some defensive areas it raises questions, about the risk of the growth being achieved, e.g. in healthcare, or the size of the premium given the growth e.g. food retailers, compared to other areas e.g. insurance, banks.

Defensive premiums seem large given potential growth prospects

Figure 14. FY12 PE and 2013-14 forecast EPS growth*



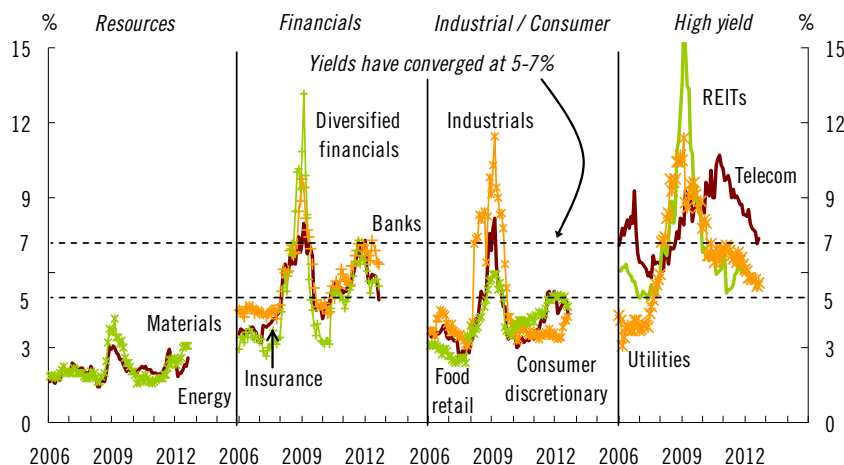
* IBES consensus estimates. Source: IBES, Datastream, Citi Research

High yields have clearly been an attraction of some defensive stocks, but aren't so much any more

Of course, the priority of getting a reliable return and the limited confidence in earnings growth have also made dividend yields important to equity investors; just as the decline in bond yields to historical lows has made high yield stocks of greater interest to fixed income investors.

There has been a flight to yield

Figure 15. ASX200 sector dividend yields

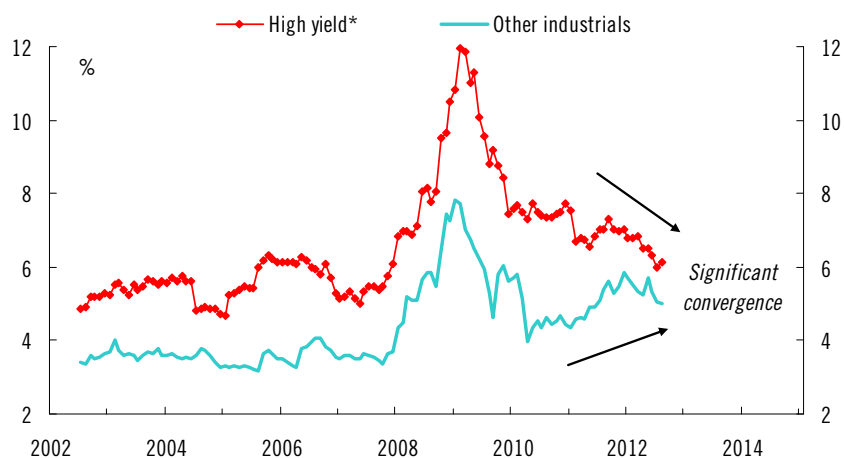


Source: Datastream, Citi Research

But the outperformance of defensive stocks has brought the yields down and more into line with those on other stocks, with yields in most sectors, excluding resources, now averaging around 5% to 7%, making that element of the return on defensive stocks not that different.

Yields have converged somewhat

Figure 16. Dividend yield of high yield sectors and other industrials



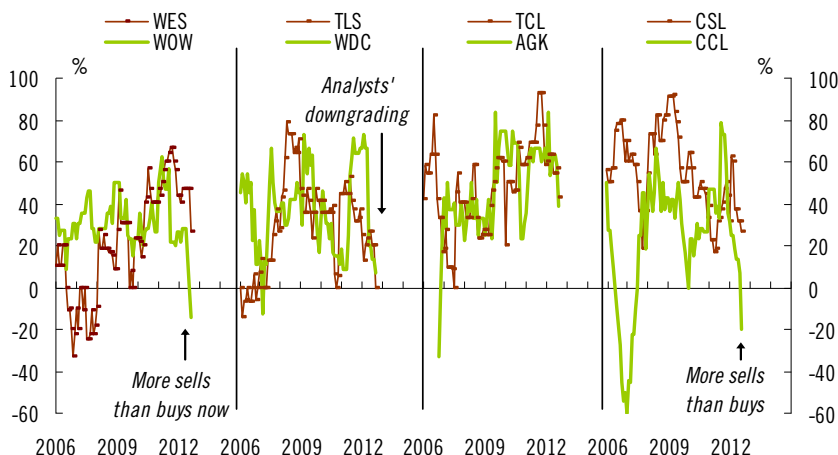
* REITs, Telecoms and Utilities. Source: Datastream, Citi Research

The markets' analysts are also now downgrading defensive stocks, but not necessarily other stocks

The strong performance, the premium valuations, and the lower yields also appear to have created reservations among the market's analysts, with the number of Buy recommendations on large defensive stocks generally declining and more Sell recommendations on some lately.

Analysts' Buy recommendations on defensives have been reduced

Figure 17. Broker analysts' recommendations (Net Buys versus Sells)*

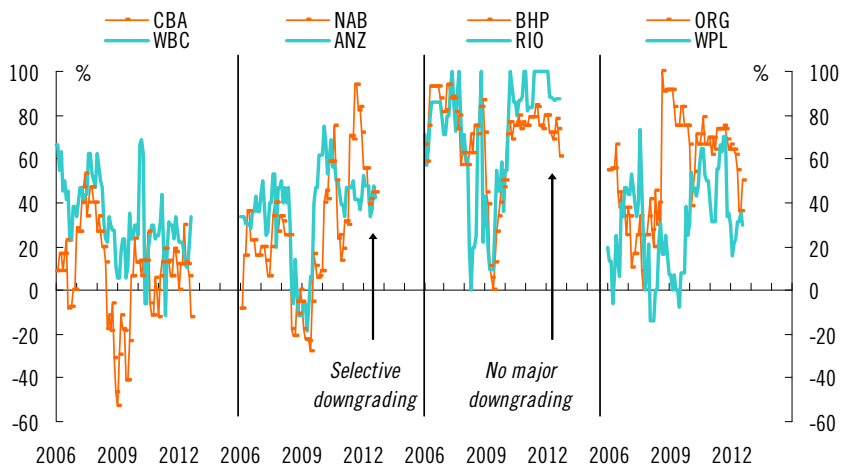


* Buy recommendations less sell recommendations as a percentage of total. Source: Bloomberg, Citi Research

This isn't generally the case for other large stocks, with Buy recommendations on bank and major resource stocks not obviously fewer lately, on figures up to end August, and in most cases materially more Buy than Sell recommendations, seemingly expecting outperformance.

Analysts' Buy recommendations on other stocks haven't changed as much

Figure 18. Broker analysts' recommendations (Net Buys versus Sells)*



* Buy recommendations less sell recommendations as a percentage of total. Source: Bloomberg, Citi Research

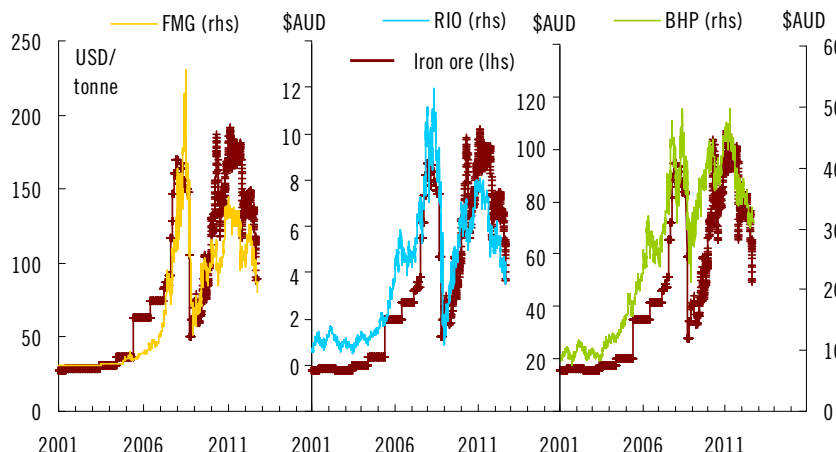
Some Specific Sectors

It's hard to go underweight resources after the decline in bulk prices looks to have overshot

A rebound in bulk prices seems probable

The plunge in iron-ore and coal prices has dragged the share prices of the major mining stocks lower, and extended the underperformance of the resource sector in the past year, but it doesn't seem a good idea to go underweight the sector now, given the scope for a rebound.

Figure 19. Mining companies share prices and iron ore prices

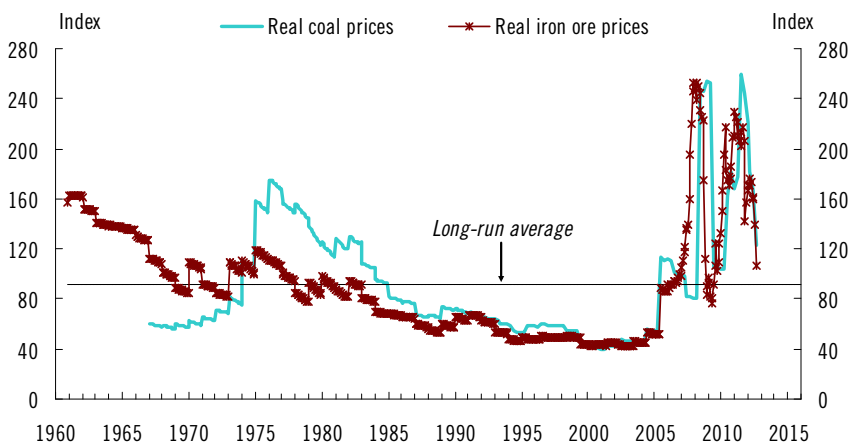


Source: Datastream, Bloomberg, Citi Research

It's worth putting the collapse in context, because it's taken iron-ore and coal prices back near their average level in real terms for the past half century, which seems too low to sustain at this point given still elevated steel output globally and the catch up still occurring in bulks supply.

Bulk prices have dropped in real terms to their average level in the past 50 years

Figure 20. Real iron ore and coal prices*



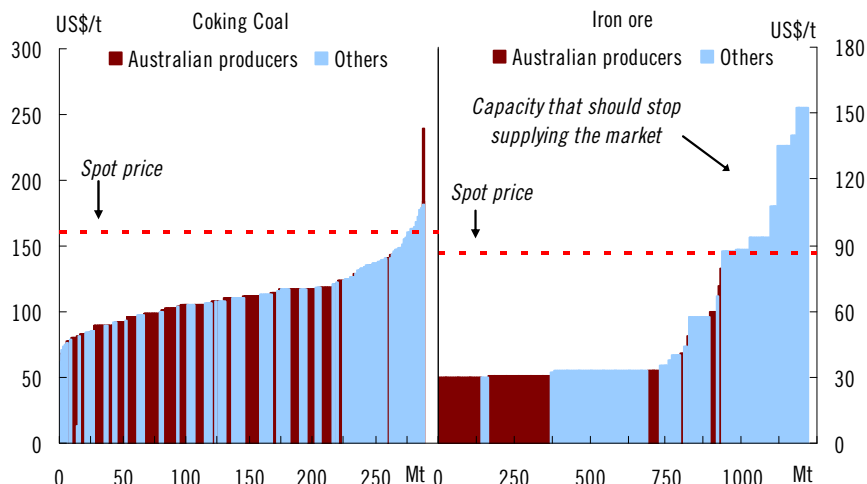
* Nominal price relative to the US CPI. Source: Bloomberg, Datastream, RBA, Citi Research

Some supply leaving the market and a moderate recovery in demand should lift the price again

The fundamental explanation for why the iron-ore price seems too low is the industry's view that it's insufficient to make the high cost marginal supply from Chinese producers profitable, so it's expected this production will leave the market at current prices, and drive a rebound.

Current prices should eliminate some marginal supply

Figure 21. Coking coal and iron ore cost curves*

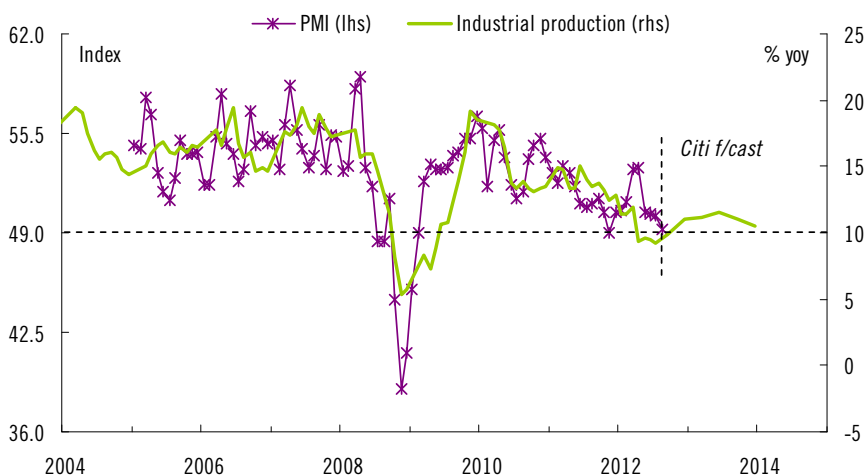


* 2011 for iron ore; 2012 for coking coal. Source: Brook Hunt, Wood Mackenzie, Company data, Citi Research

Iron-ore demand is probably also unduly low, as inventory adjustment exacerbates the slowing in steel production, and though China's industrial output only looks like picking up moderately, along with the end of the inventory cycle, it should lift steel output and iron-ore prices.

China's industrial production growth should pick-up somewhat

Figure 22. China PMI and industrial production



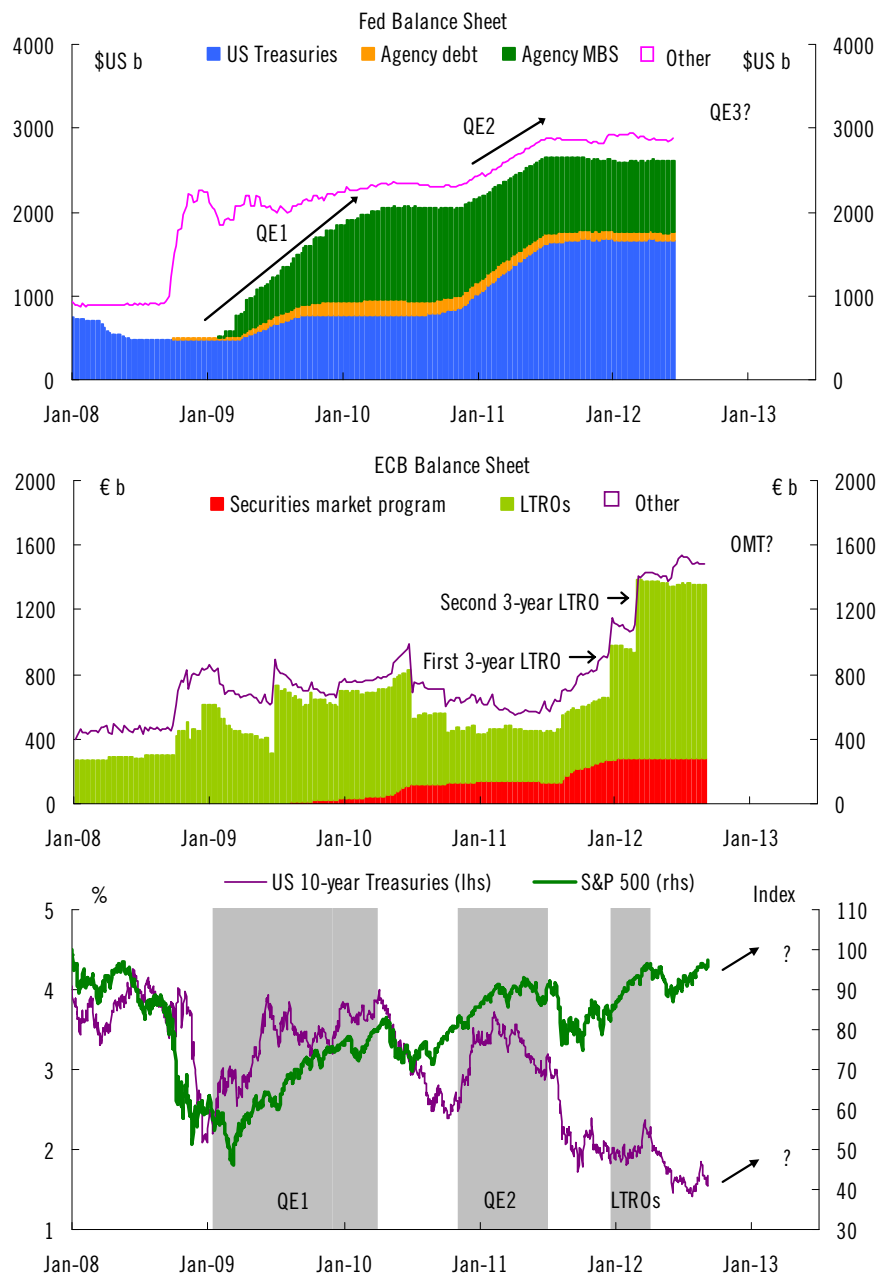
Source: Bloomberg, Citi Research

There's also the potential impact of another round of central bank quantitative easing

The ECB's new securities market purchases should get underway, and there's also the possibility of QE3 from the Fed, depending on the data on the US economy, and these liquidity-type operations that have underpinned commodity prices previously could easily do so again.

Additional liquidity may also support asset prices

Figure 23. Central banks' balance sheets and financial markets



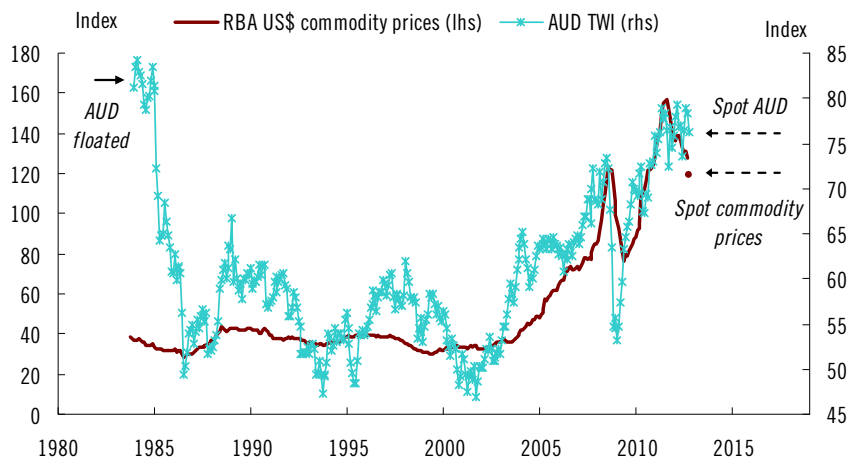
Source: Federal Reserve, ECB, Datastream, Citi Research

The Australian dollar could also adjust more after the bulk price falls, and support overseas earnings

So far the currency hasn't eased much to soften the blow of the plunge in bulk prices, and even if the prices rebound somewhat, the AUD could adjust to be more in line with the move in prices, which would support resource earnings as well as those of other overseas businesses.

The AUD may ease with lower bulk prices

Figure 24. AUD and commodity prices

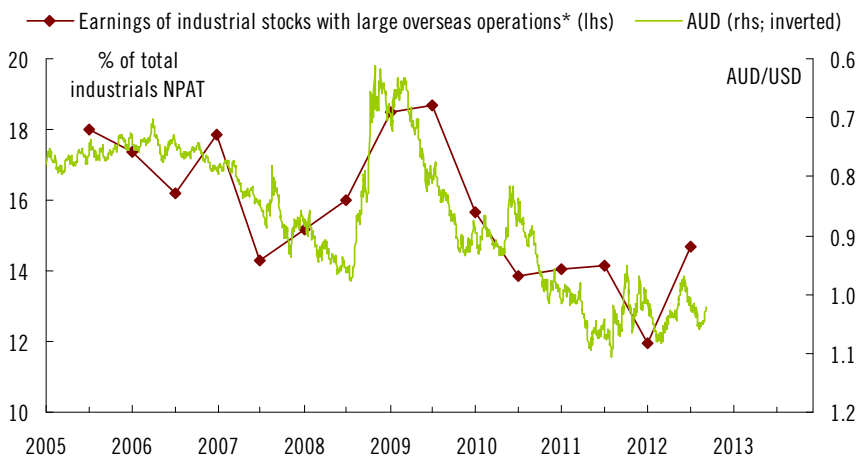


Source: Bloomberg, RBA, Citi Research

Some easing in the AUD could end up being the start of a more extended depreciation over next few years, as the resource cycle matures and the economy transitions back to growth outside of resources, which could underpin the local value of overseas earnings for a while.

The AUD may lift the value of overseas earnings of companies

Figure 25. Earnings of industrial stocks with large overseas operations and the AUD



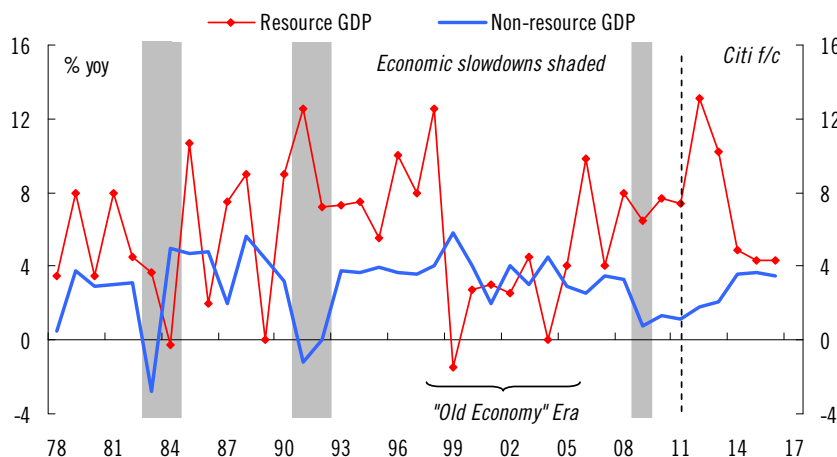
* Companies with greater than 50% of revenues earned overseas. Source: Datacentral, Worldscope, RBA, Citi Research

The transition in the economy away from resource investment should enable a recovery in housing

The peak in resource capex growth is expected to be this year, FY13, and though the spate of project deferrals shouldn't affect the capex pipeline much in the near-term, they have raised perceptions about the maturing of the resource cycle and the possible growth beyond that.

Resources capex growth may peak in FY13

Figure 26. Resources and non-resources GDP growth

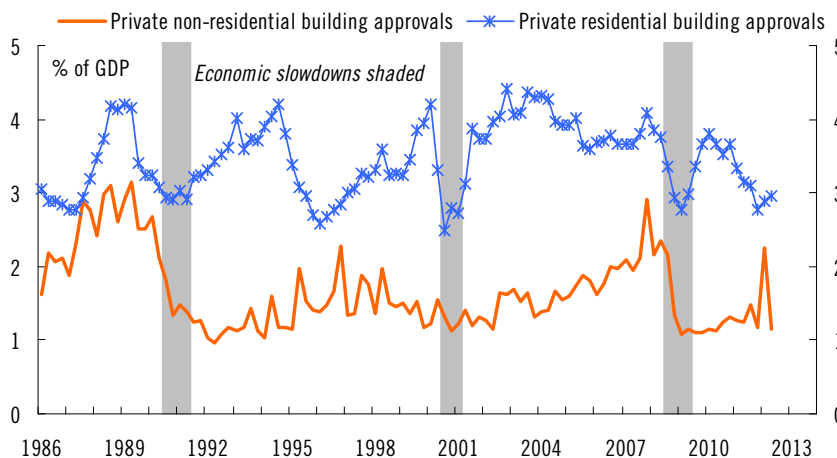


Source: ABS, ABARES, RBA, Citi Research

The transition clearly remains uncertain, but as resource capex moderates, it should enable investment elsewhere to recover, including in housing, and this may have already begun after the interest rate cuts this year, which should provide earnings growth for involved stocks.

Activity outside resources could begin to recover

Figure 27. Private residential and non-residential building approvals



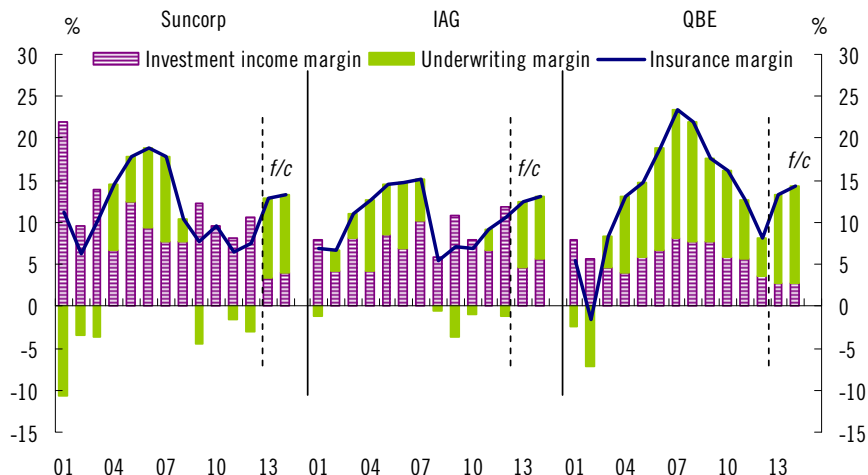
Source: ABS, Citi Research

Some other sectors still seem to offer solid growth, but it seems priced in to a certain extent

Beyond the broad macro forces, a few other sectors have been delivering solid growth, like insurance, health care, and to a lesser degree food retailing, as we've noted already, and the growth seems able to continue, in the case of insurance as margins return to mid cycle levels.

Growth prospects seem firm in insurance

Figure 28. Insurance sector profit margins*

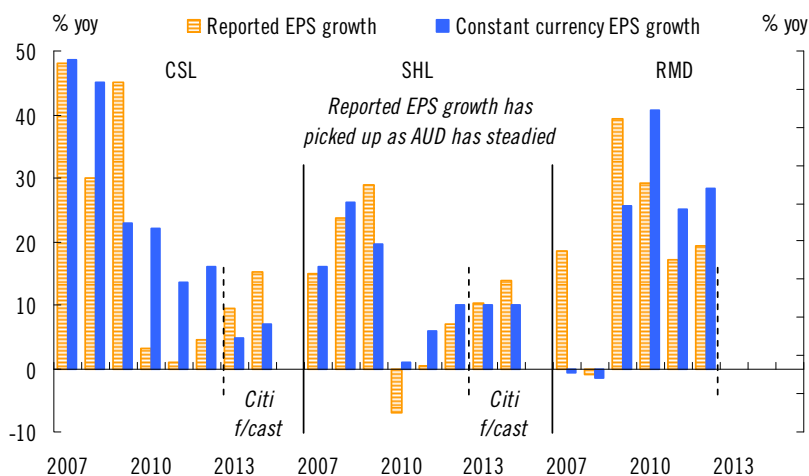


* Forecasts are Citi analyst estimates. Source: Company data, Citi Research

Likewise, in the case of health care, better growth should also continue, assuming good operating performance and less headwind from the AUD but the growth potential seems more fully reflected in share prices, which also seems the case for the major food retailers.

Health care would benefit from a lower AUD

Figure 29. Health care stocks earnings growth, reported and constant currency terms



Source: Company data, Citi Research

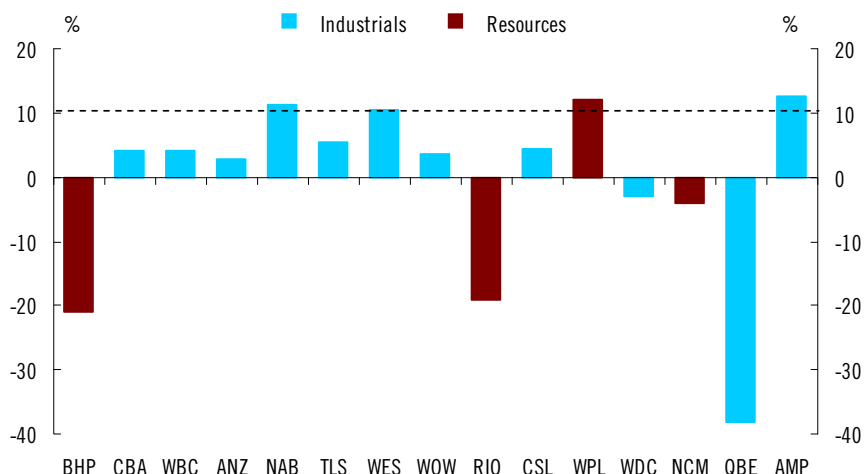
Analysis of Results

FY12 earnings growth was underpinned by the larger end of the market, excluding resources

Many of the larger stocks outside of resources delivered moderate but steady earnings growth, generally for being in more defensive industries, like food retailing, telecoms and utilities, with the banks also continuing to report fairly solid earnings growth outcomes.

Large industrial stocks reported steady growth

Figure 30. ASX largest 15 stocks FY12 earnings growth

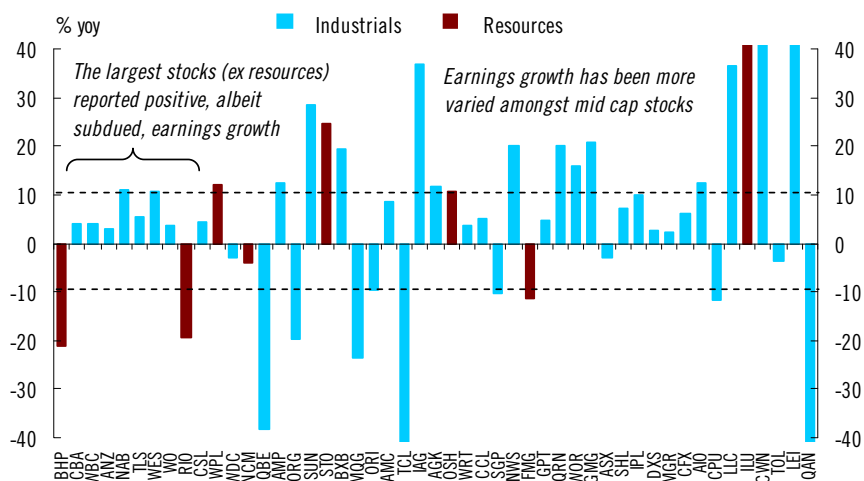


Source: Datacentral, Citi Research

Beyond the larger industrial stocks, earnings growth outcomes were more varied, though a couple of mid-sized sectors still reported strong growth, including some of the insurance and health care names, while others reported weaker earnings, including diversified financials.

Growth has been more varied beyond the large industrial stocks

Figure 31. ASX largest 50 stocks FY12 earnings growth



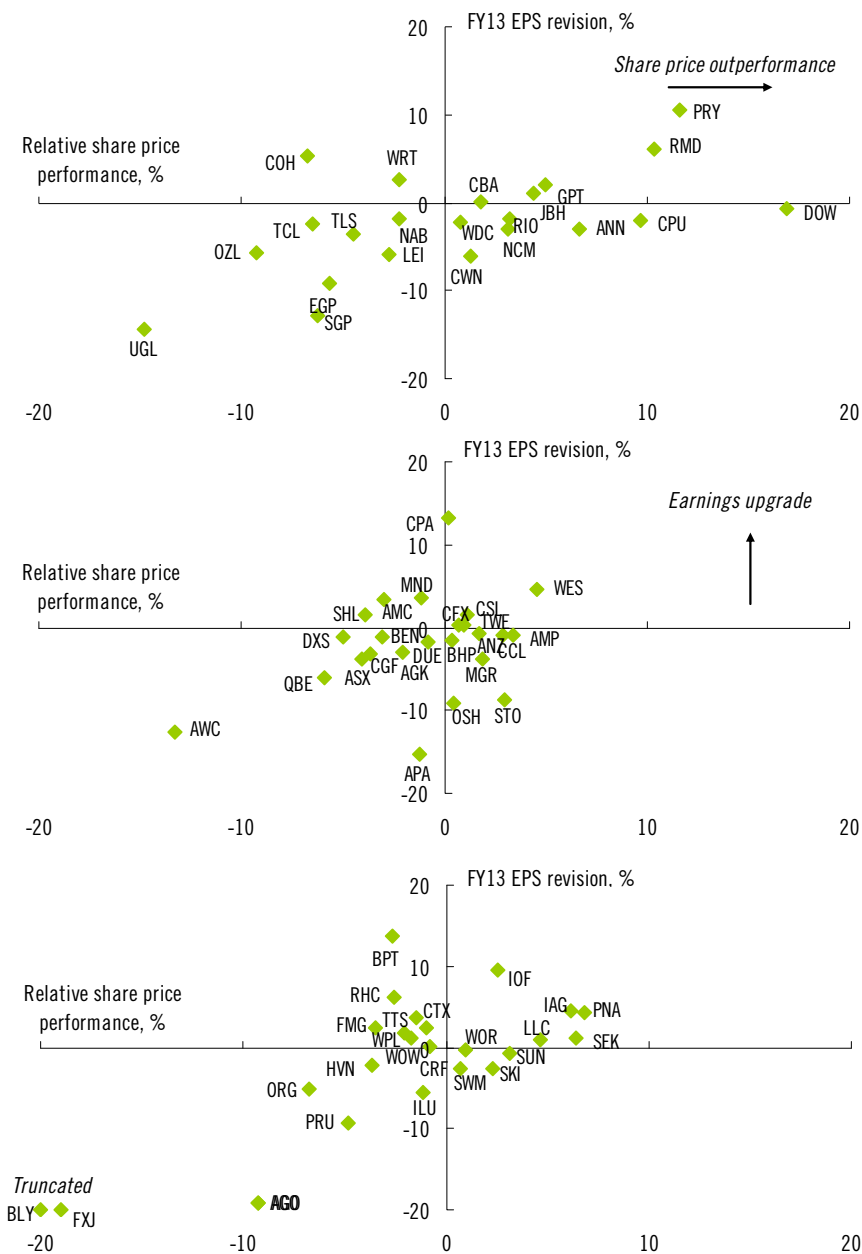
Source: Datacentral, Citi Research

Share price reactions to earnings revisions became more subdued later on in reporting

While there were sizeable share price reactions to earnings revisions early on in reporting (first panel below, showing the first third of results), they became more muted as reporting went on and the trends were clear, despite still substantial downgrading of earnings for many stocks.

Share price reactions became more subdued

Figure 32. FY13 earnings revisions and share price reaction*



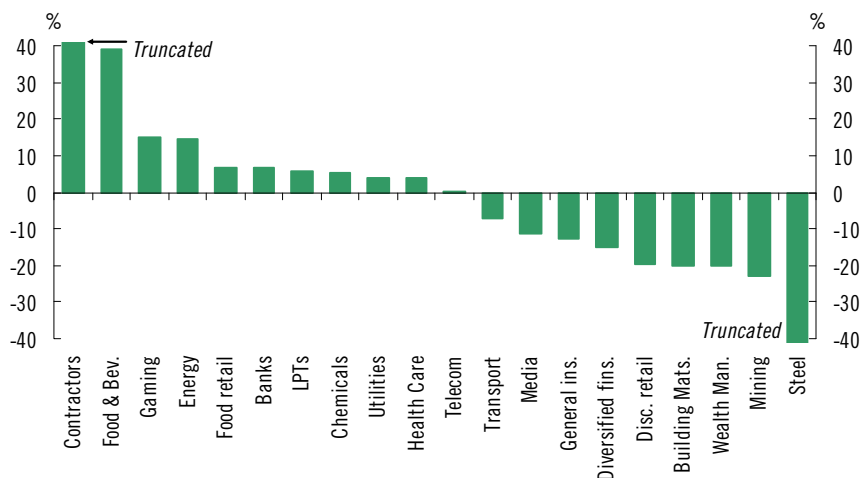
The top panel incorporates the first third of results by date, the second panel incorporates the middle third, and the third panel the final third. * Relative performance on day of and day after earnings result. Source: Datacentral, Bloomberg, Citi Research

FY12 growth was patchy across the market, and FY13 downgrades have been pushing growth the same way

With the exception of a few sectors coming off recent weakness, namely contractors and food and beverages, earnings growth remained lackluster across most areas of the market, with subdued growth among defensives, but sharp falls in more cyclical areas, including resources.

FY12 earnings fell in a number of sectors

Figure 33. FY12 NPAT growth by sector

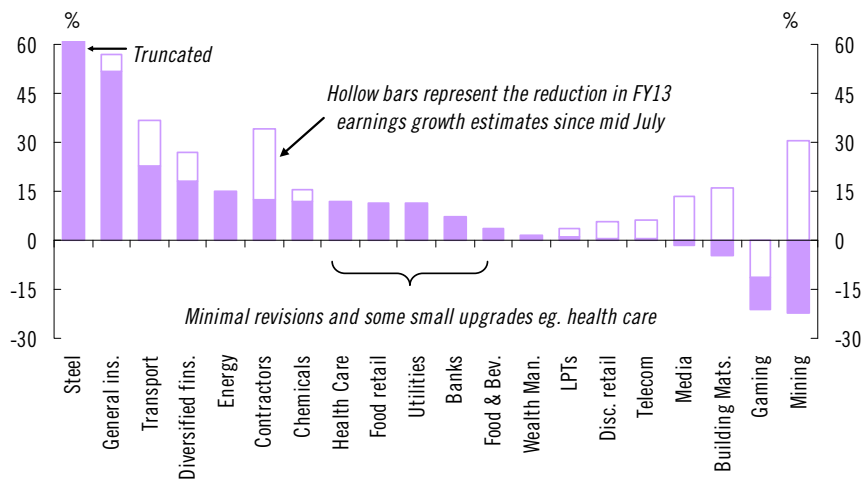


Source: Datacentral, Citi Research

Downgrades to FY13 earnings estimates have been fairly broad-based across sectors, though sharpest for mining and mining-related areas, such as contractors, while estimates for industrial (ex bank) earnings could still be a little high, with some further downgrading likely.

FY13 estimates have been scaled back across most sectors

Figure 34. FY13 forecast NPAT growth by sector*



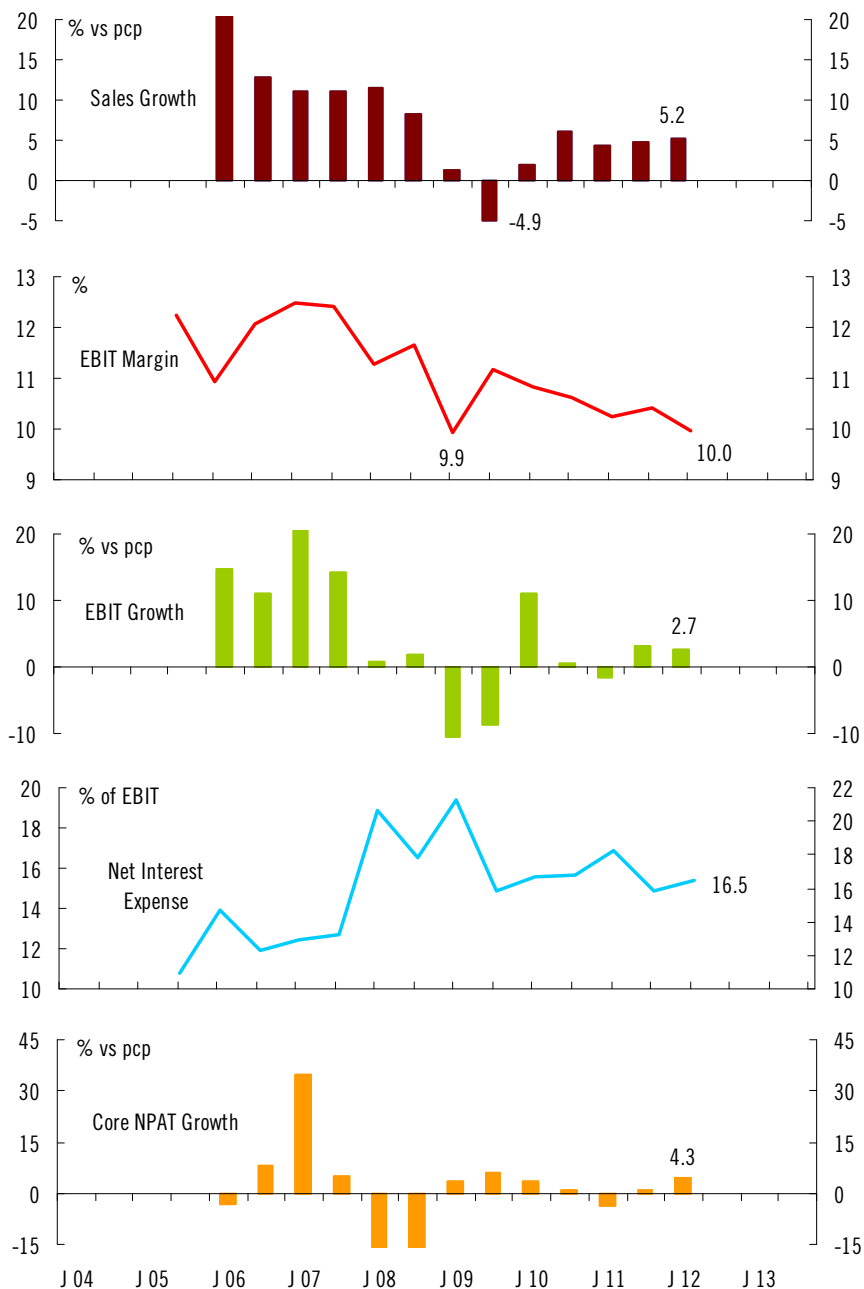
* Citi analysts' estimates, except for Transport and Steel, which are IBES estimates. Source: Datacentral, Citi Research

Conditions remained difficult for industrials, with continued margin compression

Aggregating across the sectors other than resources and financials, and looking across the common components of core earnings, operating margins look to have fallen further in the half, but a greater focus on costs and restructuring could stem any further deterioration.

Operating margins fell further

Figure 35. Industrials ex financials profit and loss items



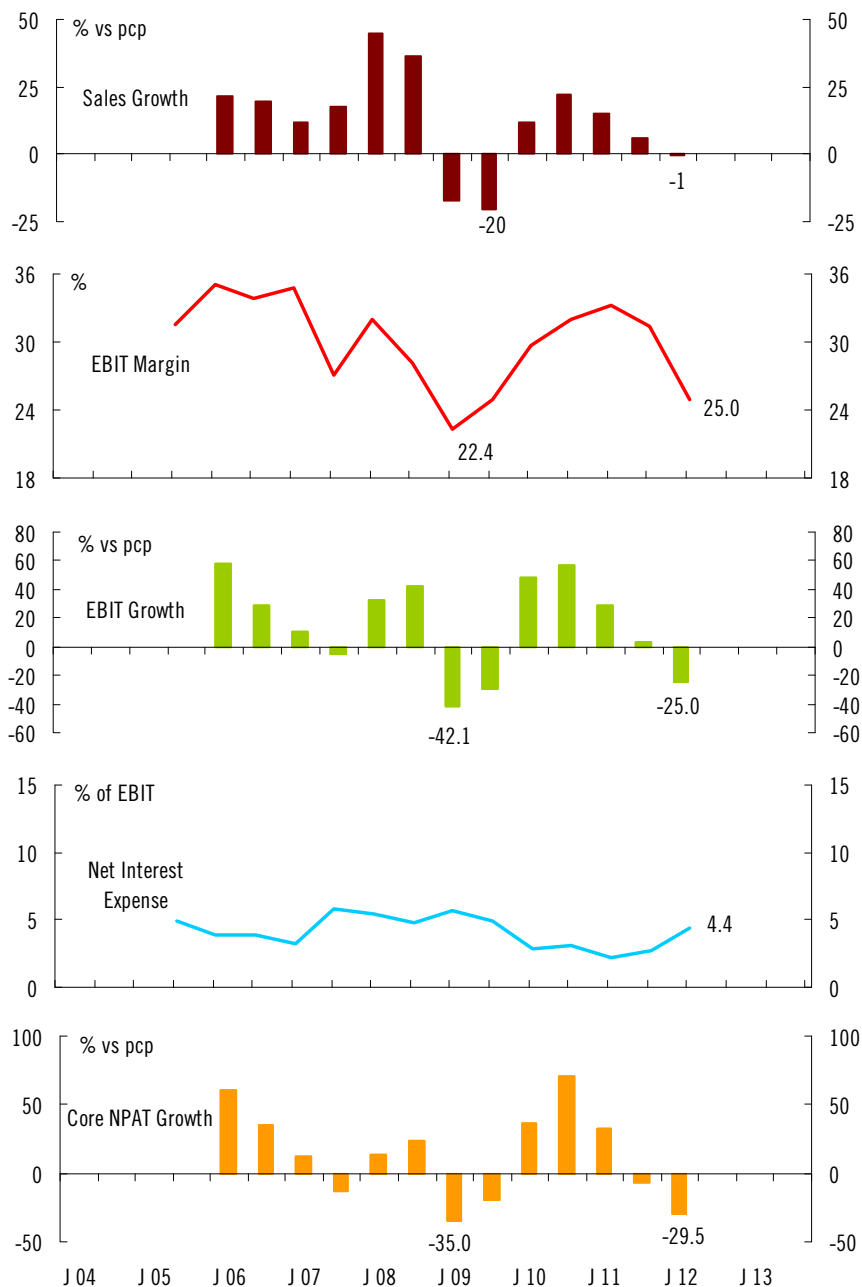
Source: Datacentral, Citi Research

Resources earnings fell sharply, with margins dropping back near lows of a few years ago

With the fall in commodity prices over the past year, and large capex plans underway across the sector, resources margins fell sharply in the June half, sitting not far from their GFC low, with further falls in bulk prices after the fiscal year end potentially seeing further compression.

Resources earnings fell sharply

Figure 36. Resources profit and loss items



Source: Datacentral, Citi Research

Figure 37. Companies mentioned

Code	Name	Price (6-Sep)	Rating	Code	Name	Price (6-Sep)	Rating
AGK	AGL Energy Ltd	15.36	2	LLC	Lend Lease Corp	8.30	1
AIO	Asciano Limited	4.46	--	MGR	Mirvac Group	1.43	2
AGO	Atlas Iron Ltd	1.27	2	MND	Monadelphous	19.80	2
AMC	Amcor Limited	7.68	1	MQG	Macquarie Group	27.57	2
AMP	AMP Ltd	4.41	2	MTS	Metcash Ltd	3.71	1
ANN	Ansell Ltd	15.92	1	MYR	Myer Holdings Ltd	1.90	2
ANZ	ANZ Banking Group	24.21	1	NAB	Nat. Australia Bank	25.11	2
APA	APA Group	4.84	2	NCM	Newcrest Mining Ltd	25.60	2
ASX	Aust. Sec. Exchange	30.37	3	ORG	Origin Energy Ltd	11.75	1
AUT	Aurora Oil & Gas	3.28	3H	ORI	Orica Limited	23.63	1
AWC	Alumina Ltd	0.75	3	OSH	Oil Search Ltd	7.44	1
BEN	Bendigo Bank Ltd	7.60	2	OZL	OZ Minerals Ltd	6.45	1
BHP	BHP Billiton Ltd	31.34	1	PDN	Paladin Energy Ltd	1.23	1H
BLD	Boral Ltd	3.35	3	PNA	PanAust Limited	2.69	1H
BLY	Boart Longyear Ltd	1.27	1	PRU	Perseus	2.71	1
BPT	Beach Energy Limited	1.26	2H	PRY	Primary Health Care	3.70	1
BXB	Brambles Ltd	6.91	--	QAN	Qantas Airways Ltd	1.20	--
CBA	Commonwealth Bank	54.72	1	QBE	QBE Insurance	12.37	2
CCL	Coca-Cola Amatil Ltd	13.81	2	QRN	QR National Limited	3.45	--
CFX	CFS Retail Property	1.96	2	RHC	Ramsay Health Care	24.72	3
CGF	Challenger Ltd	3.42	1	RIO	Rio Tinto Ltd	50.16	1
COH	Cochlear Ltd	68.30	3	RMD	ResMed Inc	3.80	1
CPA	Comm Property Office	1.06	2	SEK	SEEK Ltd	6.72	2
CPU	Computershare	8.73	2	SGP	Stockland	3.36	1
CRF	Centro Retail Australia	2.16	1	SHL	Sonic Healthcare	13.29	2
CSL	CSL Ltd	45.09	2	SKI	Spark Infrastructure	1.62	2
CSR	CSR Ltd	1.37	2	STO	Santos Ltd	11.65	1
CTX	Caltex Australia	15.78	3	SUN	Suncorp Group Ltd	9.11	1
CWN	Crown Ltd	9.20	1	SWM	Seven West Media	1.36	1
DJS	David Jones Ltd	2.42	2	SYD	Sydney Airport	3.20	--
DOW	Downer EDI Ltd	3.31	1	TAH	TABCORP Holdings	3.05	2
DUE	DUET Group	2.14	2	TCL	Transurban	6.02	2
DXS	Dexus Property Group	0.98	2	TLS	Telstra Corp Ltd	3.84	2
EGP	Echo Entertainment	4.17	2	TOL	Toll Holdings Ltd	4.60	--
FMG	Fortescue Metals	2.97	1	TTS	Tatts Group Ltd	2.75	3
FXJ	Fairfax Media Ltd	0.43	2	TWE	Treasury Wine Est.	4.82	3H
GNC	Graincorp Limited	9.22	2	UGL	UGL Ltd	10.51	2
GPT	GPT Group	3.61	2	WDC	Westfield Group	10.30	2
HVN	Harvey Norman	1.99	3	WES	Wesfarmers Ltd	35.42	3
IAG	IAG Ltd	4.25	1	WHC	Whitehaven Coal	3.05	1
ILU	Iluka Resources Ltd	8.84	1	WOR	WorleyParsons Ltd	25.30	2
IOF	Investa Office Fund	2.88	2	WOW	Woolworths Ltd	30.56	2
IPL	Incitec Pivot	2.78	2	WPL	Woodside Petroleum	34.93	1
JBH	JB Hi-Fi Ltd	9.16	3	WRT	Westfield Retail Trust	2.97	2
LEI	Leighton Holdings	14.95	2				

Source: Datacentral, Citi Research

Notes

Notes

Appendix A-1

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Craig Williams, Analyst, holds a long position in the securities of Australia and New Zealand Banking Group Ltd.

Trevor Huynh, Associate, holds a long position in the securities of WorleyParsons Ltd.

Nigel Pittaway, Analyst, holds a long position in the securities of AMP Ltd.

A member of the household of Trevor Huynh, Associate, holds a long position in the securities of Leighton Holdings Ltd.

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Ltd, OZ Minerals Ltd, Paladin Energy Ltd, PanAust Limited, Qantas Airways Ltd, QR National Limited, Ramsay Health Care Ltd, Rio Tinto Ltd, Stockland, Sonic Healthcare Ltd, Spark Infrastructure Group, Santos Ltd, Seven West Media Ltd., Transurban, Telstra Corp Ltd, Toll Holdings Ltd, Treasury Wine Estates, Westfield Group, Wesfarmers Ltd, WorleyParsons Ltd, Woolworths Ltd, Woodside Petroleum Ltd, Westfield Retail Trust.

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