Why the earnings upgrade cycle is still young

Our weekly view on Australian Equities

29 April 2021

Earnings upgrades to persist

After a tumultuous 2020 for corporate earnings, the Australian equities earning cycle is starting to gather momentum. Consensus earnings upgrades are at all-time highs, providing a platform for the start of a V-shaped recovery for earnings.

The strongest earnings upgrades over the last 6 months have been in Australia (compared to Europe, the UK and the US) and it remains one of the strongest domestic upgrade cycles since 2009-2010.

See report: Resilient US equity market reluctant to pass the baton

Inside this note, we show how a sustained earnings upgrade cycle has the potential to underpin further appreciation of the S&P/ASX 200 index, particularly in cyclical stocks where the Wilsons Australian Equity Focus List is overweight.

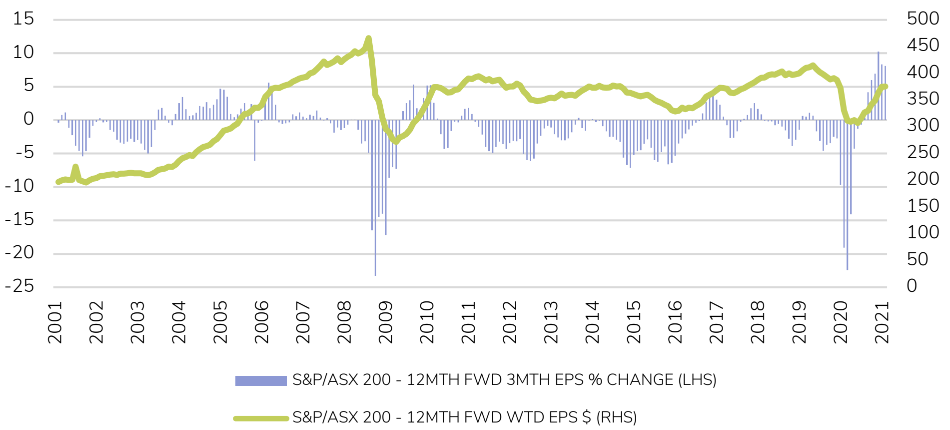
Factors driving the earnings cycle

Australian earnings revisions have been in earnings upgrade mode since October 2020, accelerating into year-end as vaccine news provided the 'ticket' to normality in the eyes of investors for corporate earnings.

Heavyweight sectors, financials and materials, have done much of the heavy lifting so far in 2021 as the market begins to consider not only the recovery in COVID-19 earnings but the prospect of cyclical earnings recovery into FY22 and beyond.

The pandemic saw a ~25% reduction in earnings in 2020, which is part of the reason why this earnings cycle is likely to emerge as one of the strongest we have seen. From a low starting point, corporate earnings estimates have recouped ~70% of these losses.

Exhibit 1: Domestic earnings upgrade cycle has emerged, with EPS estimates still below 2019 levels



Source: Refinitiv, Wilsons.

The market is likely to remain in upgrade mode over the next 6 months due to:

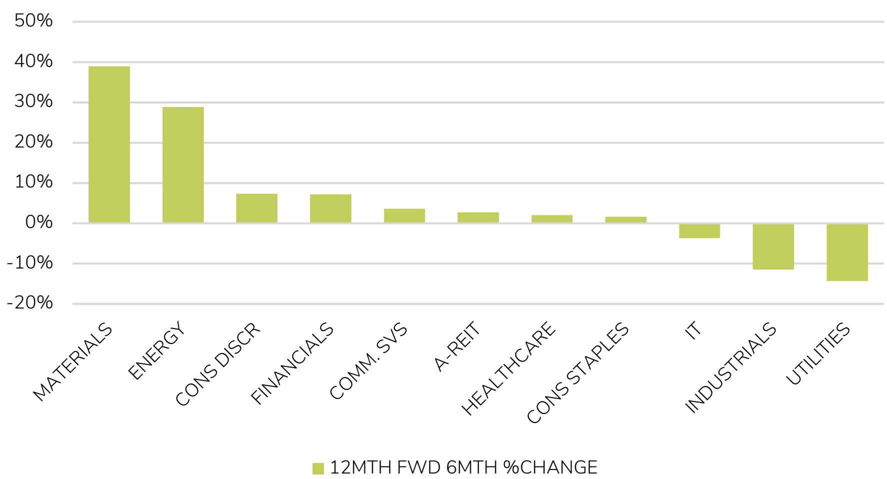
1. COVID-19 vaccine providing the pathway to broader economic reopening.
2. A global reopening will be a supportive backdrop for resources. We believe the duration of the commodity cycle will be longer than the market expects.
3. Domestic economic data is proving to be stronger than anticipated.
4. EPS earnings are still forecast to be below pre-COVID-19 levels by the end of FY22, providing further headroom for the market.

Cyclicals keep the baton

Over the last 3 months, earnings upgrades have been stronger for the ASX 200 cyclical companies compared to defensive or growth companies.

The easing of domestic lock-down restrictions (particularly in Victoria) as well as positive vaccine news last October and maximum policy response settings, have seen cyclical companies receiving the bulk of the upward earnings revisions relative to the defensive/high growth sector.

Exhibit 2: Cyclical sector earnings have risen the greatest over the last 6 months.



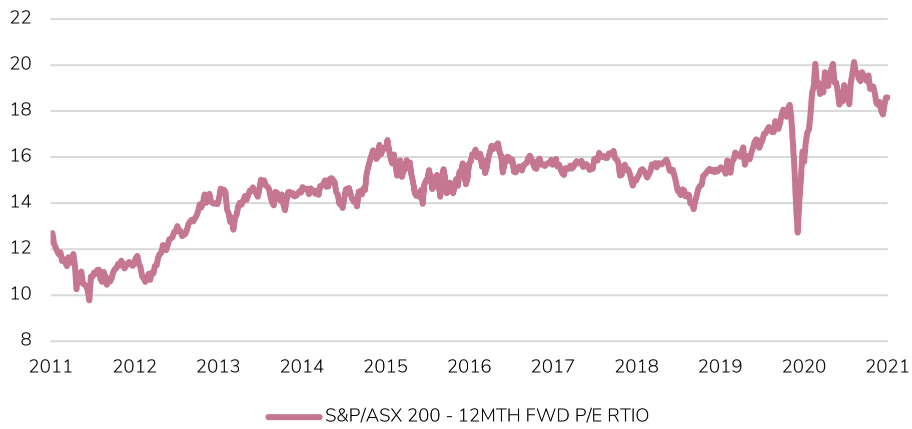
Source: Refinitiv, Wilsons.

Price-performance has followed this trend, with materials (+22%) and energy (+16%) outperforming IT (8%) and utilities (-13.6%) over the last 6 months.

Earnings revisions have increasingly become a key driver of stock performance as (PE) multiple expansion appears to have peaked. This relationship between earnings upgrades and price momentum is likely to remain in place over the coming 6-12 months.

As strong domestic and global economic data continues to beat expectations, earnings upgrades are likely to continue to feature. This is likely to benefit cyclicals over defensives, as these sectors typically have greater leverage to an expanding economy.

Exhibit 3: ASX 200 PE ratio has likely peaked – earning revisions are now a stronger driver of price than multiple expansion



Source: Refinitiv, Wilsons.

Earnings upgrades can broaden

Although earnings upgrades have been concentrated towards cyclicals, 8 out of the 11 sectors have had positive earnings revisions over the last 6 months. The improving economy is benefitting a broad base of different sectors, not just cyclicals.

We think that this breadth of sectors receiving upgrades can continue, particularly as service based industries and companies begin to benefit from broader reopening. This could assist both REITs and industrials where revisions have been only just slightly positive in the case of REITs and negative in the case of industrials.

Energy, Financials and Materials performed well but still have upside risk

We believe that the cyclical sectors of energy and financials still have earnings upgrade potential. Analysts downgraded financials and resources companies during the pandemic with a fear of a lengthy economic downturn, which would have impacted these sectors substantially.

However, the quick recovery in the global and domestic economy has provided a supportive backdrop for these sectors – providing a bullish earnings outlook, still with risk to the upside.

Global reopening supporting resources

Over the past 3 months, the strength of resources has been supported by the global recovery.

Energy revisions have risen off a low earnings base – earnings fell 60% in FY20 – but we still think there is more upside. We believe oil prices are likely to be higher by the end of 2021, given a return of demand and closely controlled supply. Energy companies that offer leverage to the oil price should generate earnings and price upgrades.

Short-term dynamics are driving the strength in the iron ore price. We still believe that the dynamics behind elevated prices will persist over 2021 but start to fade by the end of the year, possibly preventing further substantial earnings upgrades for iron ore over the next 12 months.

We have a higher conviction on copper miners due to an improving copper price, which we believe has more upside than iron ore, as the global recovery drives demand and supply potentially tightens over the next 12-24 months.

Financials: low starting point + domestic recovery

The upcoming bank results season (starting next week) should be well received by the market. The sector should continue to see upside from the domestic economic recovery, improving lending growth/housing cycle and strategic initiatives like cost-cutting.

The recent Bank of Queensland (BOQ) result showed that the market will still buy the upgrade story, despite banks having outperformed the market by ~25% since November 2020.

For our preview on the banks see: [2Q Australian Equity Outlook]

Technology sector still seeing (revenue) upgrades

The technology sector is one of the few sectors to have earnings downgrades over the previous 3 months.

However, over the last 6 months the technology sector has seen the second-highest level of revenue upgrades. This is particularly important for Australian technology, given ~65% of the sector is still pre-earnings (EPS), with the market focusing primarily on revenue growth/revenue multiples as the reference point.

As a consequence, despite that lack of positive earnings momentum, the sector has not dramatically underperformed the broader market. In fact, over the last month the sector has recouped more than half of the pullback from earlier in the year.

Not the time for defensives

In the recovery/expansion stage of the cycle, defensive companies generally underperform. During the expansionary stage post the GFC, healthcare and utilities underperformed the market considerably. The Focus List is currently underweight consumer staples, healthcare and utilities as we believe other segments of the market will outpace these.

How to position for the upgrade cycle

- **Australian equity upgrade cycle is not finished. We expect further earnings upgrades to consensus over the next 6-12 months.**
- **Remain overweight cyclicals. Financials and resources are our preferred choices.**
- **Underweight defensives. The expansionary stage of the cycle is typically a tough backdrop for defensives**

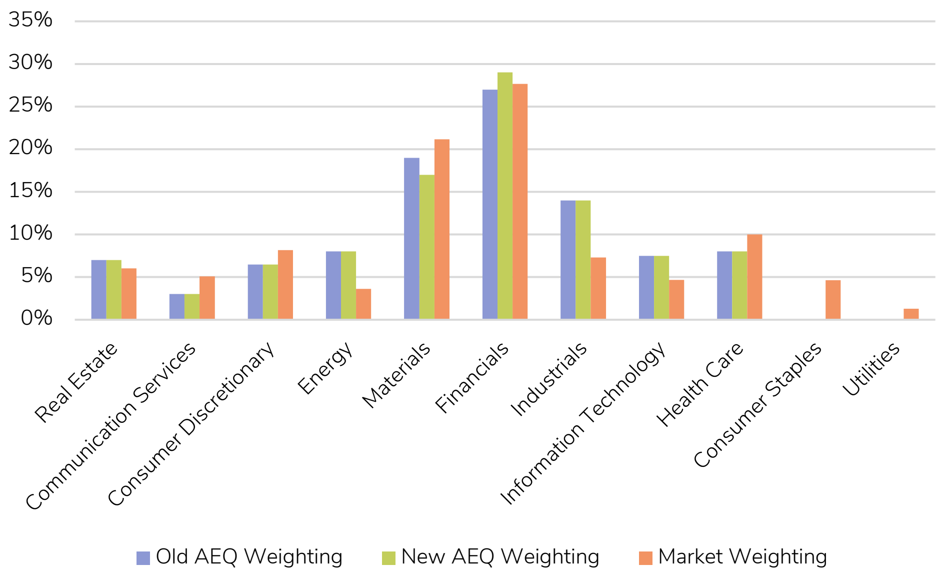
Focus List: Adding to the banks ahead of results

We have added +2% to our banks' weighting, adding to Westpac (WBC) – our preferred bank with the prospects for refreshed strategy and new efficiency program to revealed at the results.

This has been funded by a 2% reduction to BHP Group (BHP) and leaves the Focus List 1.2x overweight the banks vs market (up from 1.1x).

The prospect for stronger relative performance from the banks over BHP in coming quarters is based on our higher conviction to banks' earnings upgrades and still attractive valuations (20% under long term average), and potential peaking in the iron ore price which we think will present a challenge to BHP share price performance.

Exhibit 4: Australian Equity Focus List Sector weights new vs old



Source: Refinitiv, Wilsons.

Focus List earnings momentum

Ticker	Name	EPS Revisions FY2 (3mths % Change)	EPS Revisions FY2 (6mths % Change)	Price 3mth % Change	ISG Comment
ALL	Aristocrat Leisure	1%	-1%	24%	Stronger digital sales/operating trends.
ANZ	ANZ	11%	15%	25%	Housing cycle, bad debt reversals.
APT	Afterpay	-19%	-19%	5%	Upgrade revenue offset by higher costs as company lifts investment in EU/US/Asia.
AVN	Aventus Group	0%	0%	6%	N/A
BHP	BHP Group	23%	62%	13%	Commodity price revisions - particularly iron ore and copper.
CSL	CSL	-5%	-7%	-6%	Concerns around a Plasma based earnings hole emerging in FY22E .
EML	EML Payments	-5%	-7%	35%	Earnings dilution from recent UK acquisition.
GMG	Goodman Group	2%	5%	6%	Upgraded development pipeline.
JHX	James Hardie	8%	14%	20%	US Housing cycle upgrades.
MQG	Macquarie Group	3%	2%	15%	Rising asset prices/cyclical recovery - offset by large upgraded FY1 on back of "windfall energy" earnings.
NAB	NAB	8%	8%	13%	Housing cycle, bad debt reversals.
NST	Northern Star	-16%	-28%	-8%	Negative gold price revisions and higher USD.
NWS	News Corporation	21%	29%	34%	Cyclical recovery in ad-cycle, cost out program larger than expected.
OZL	Oz Minerals	18%	23%	31%	Significant copper upward copper price revisions.
RMD	Resmed	2%	5%	0%	Strong 2Q Results - drove upgrade rounds. Reporting results 29/04/2021.
RWC	Reliance	7%	6%	16%	Housing cycle, northern winter cold snap.
STO	Santos	25%	37%	6%	Oil price revisions.
SUL	Super Retail	3%	13%	19%	Domestic consumption trends.
SYD	Sydney Airport	-6%	-6%	-8%	EBITDA estimates have yet to begin the upgrade cycle.
SVW	Seven Group	6%	7%	-3%	Iron ore prices, order book, cyclical recovery exposure.
TCL	Transurban	2%	1%	1%	Low single digit EBITDA upgrade in April, potentially the first of this cycle. Investor day is on 03/05/2021
TLX	Telix	N/A	N/A	7%	EPS not relevant given business is pre-earnings.
WBC	Westpac	4%	0%	25%	Housing cycle, bad debt reversals, market not giving WBC any credit for new cost savings.
WOR	Worley	-12%	-12%	-12%	Market pushing out post COVID recovery.
XRO	Xero	-9%	-3%	-3%	Earnings dilution from a series of recent acquisitions
					Key: Results/price sensitive event expected in May.

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. Wilsons Corporate Finance Limited ABN 65 057 547 323, AFSL 238 383 has not acted in an advisory capacity to any of the stocks mentioned in this research.

Wilsons Corporate Finance Limited ACN 057 547 323, AFSL 238 383 acted as Joint Lead Manager and Joint Underwriter to the Telix Pharmaceuticals Limited November 2017 IPO for which it received fees or will receive fees for acting in this capacity. Wilsons Advisory and Stockbroking Limited may have a conflict of interest which investors should consider before making an investment decision. Wilsons Advisory and Stockbroking Limited, Wilsons Corporate Finance Limited and its related bodies corporate trades or may trade as principal in the securities that are subject of the research report.

Wilsons Corporate Finance Limited ACN 057 547 323, AFSL 238 383 acted as Co-Manager in the November 2019 placement EML Payments Ltd securities for which it received fees or will receive fees for acting in this capacity. Wilsons Advisory and Stockbroking Limited may have a conflict of interest which investors should consider before making an investment decision. Wilsons Advisory and Stockbroking Limited, Wilsons Corporate Finance Limited and its related bodies corporate trades or may trade as principal in the securities that are subject of the research report.

All figures and data presented in this research 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