AUGUST REPORTING SEASON UPDATE – WEEK TWO.

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As the 2024 reporting season moves past its second week, the Australian equity market has experienced a mix of positive and negative surprises that have shaped investor sentiment and market reactions.

Earnings surprises have been a key driver of market movements in week two, with a net beat of 16% in earnings per share (EPS) surprises, continuing the 19% net beat observed since the start of the season according to Macquarie Equity Research.

This trend highlights a market that is resilient, with companies managing to exceed expectations, particularly in terms of margins. Interestingly, the margin improvements are more often the result of lower tax and interest costs rather than operational efficiencies, on contrast to the divergence from the U.S. market where cost reductions have been a more significant factor in margin surprises.

Despite the positive earnings surprises, a pattern of downgrades in forward earnings estimates has emerged, particularly for fiscal year 2025. The ratio of consensus downgrades to upgrades has been running at 2:1 (Macquarie Research), with Real Estate and Financials being the most impacted sectors. These downgrades suggest that while companies may be managing short-term challenges effectively, there are growing concerns about their ability to maintain growth in a potentially slowing economic environment.

Sector Performance: Cyclical Retailers Shine, Media Struggles

In terms of sector performance, cyclical retailers were the standout performers during week two, with companies such as **JB Hi-Fi (JBH)** and **Temple & Webster (TPW)** delivering strong earnings beats which have been met with rare upgrades to FY25 estimates from the street. The success of these companies can be attributed to solid execution and potentially an improving consumer environment. However, it remains too early to definitively attribute this performance to broader economic factors, since the retail sector is notoriously volatile and sensitive to changes in consumer sentiment and spending patterns.

In contrast, the Media & Entertainment sector has struggled, with companies like **Seven West Media (SWM)** and **SEEK (SEK)** posting substantial earnings misses. These misses have been met with muted price reactions compared to the size of the downgrades, possibly due to investors rotating into the sector in anticipation of future interest rate cuts. However, the ongoing challenges faced by more traditional media companies, including declining advertising revenues and increased competition from digital platforms and shifting consumer preferences, suggest that the sector may continue to face headwinds in the near term.

Guidance: A Major Disappointment

One of the most significant themes of the second week has been the disappointing guidance provided by many companies. **NRW Holdings (NWH)** was one of the rare companies that issued guidance that was materially ahead of consensus expectations. In contrast, six companies provided guidance that fell significantly below expectations, with major disappointments coming from **SEEK (SEK)**, **James Hardie Industries (JHX)**, **Mirvac (MGR)**, **Origin Energy (ORG)** and **Cochlear (COH)**.

This cautious approach to guidance is reminiscent of the conservatism seen in previous reporting seasons, where companies have been wary of providing overly optimistic outlooks in the face of macroeconomic uncertainties. Currently, the key uncertainty revolves around the timing and impact of potential interest rate cuts in both Australia and the U.S.

The conservative guidance has fuelled concerns that earnings growth may be more limited in the near term, leading to further downgrades in forward estimates. This trend of cautious guidance, coupled with the ongoing downgrades, suggests that companies are preparing for a more challenging economic environment.

Downgrades: The Persistent Trend

Despite the positive earnings surprises reported in week two, the overall trend of downgrades has persisted, particularly for FY25 estimates. These downgrades have been widespread, impacting sales, margins, and dividends. The breadth of the downgrades is particularly concerning for ASX 100 companies, where the impact on aggregate EPS growth has been more pronounced compared to smaller companies.

The factors driving these downgrades are varied. Weaker-than-expected sales growth, shrinking margins, and conservative assumptions on dividend payouts have all contributed to the downward revisions. For example, while some companies have reported better-than-expected margins for FY24, these improvements have not translated into positive revisions for FY25.

The market appears cautious about the sustainability of these gains, especially in light of potential economic slowdowns and ongoing challenges in key sectors such as real estate and financials.

The Role of Interest Rates: A Key Uncertainty

One of the major uncertainties facing the market is the potential impact of future interest rate cuts, both in Australia and the U.S. The timing and magnitude of these cuts will likely have a significant impact on market dynamics, particularly in sectors such as Real Estate and Financials, which are highly sensitive to changes in interest rates. 10-year bond rates have fallen in both the U.S. and Australia given the likely trajectory of cash rates.

Tyndall has recently moved to an overweight position in REITs given it seems likely that peak rates have been reached in both the U.S. and Australia. REITs have presented as attractively valued for a while and we have been waiting for a catalyst to act. The uncertainty surrounding interest rates is likely to remain a key factor influencing market dynamics in the coming months, and investors will need to closely monitor developments in this area.

The Outlook for FY25: A Cautious Approach

Although it's only early in this reporting season, looking ahead to FY25 the outlook remains cautious, with ongoing concerns about the sustainability of current earnings growth and the potential impact of macroeconomic uncertainties.

The trend of downgrades to forward earnings estimates, particularly for FY25, suggests that companies are preparing for a more challenging economic environment, with weaker sales growth, shrinking margins, and conservative assumptions around dividend payouts.

Reporting season can be a happy hunting ground for alpha as the market often overreacts to results both on the up and downside. So far, we have taken the opportunity to initiate a new position in SEEK that disappointed the market on result day – being down some 10% – and thus providing a wonderful entry point for a long-term patient investor. Funding for this was by taking some profits in Goodman Group (GMG) and ResMed (RMD), both of which had rallied significantly.

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We are cautious on the FY25 outlook

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