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# Increasing pressure on the consumer

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**The main focus during the profit reporting season was understandably on earnings and dividends, but at Ausbil Investment Management we have also studied a range of market trends such as increasing pressure on the consumer and the growing importance of culture and staff engagement within listed entities.**

As a starting point, it is worth noting that housing prices have actually been very resilient to date and this strength has created a positive wealth effect, but we believe Australian housing has peaked and this is a key overarching theme that will affect all of us.

We are seeing evidence of housing prices cooling, for example, the Spring selling season started early and it's been quite flat. One reason for this is that the Banks have been adjusting their approach to lending, by granting fewer interest only loans.

Another is that the level of income you require to buy a home has never been higher. The discovery of fraudulent loan applications, where borrowers have overstated their disposable income and underestimated their cost of living, also has the potential to soften housing demand.

Although housing construction levels may be topping out, we think the baton is being passed to Infrastructure, where we forecast spending to double to record levels over the next five years. This is obviously positive for the economy and parts of the share market.

Household income, meanwhile, is an important area of focus for us. We believe the rate of household income growth is slowing as disposable incomes fall. The consumer is clearly under pressure. She is being enveloped in a pincer movement as rising costs of fuel, utilities, health care and education simultaneously attack all flanks. This is an ongoing area of concern for us as the ramifications on certain areas of the market could be substantial.

Being careful with your money is the predominant consumer sentiment. Almost everything is expensive in Australia – not just coffees and avocado on toast – concerns about the rising cost of living, such as utility prices and the cost of insurance, means consumers are becoming more discerning in their spending habits.

The consumer, however, is a savvy shopper. She's still spending on experiential items – travel, luxury items, restaurant outings - but she's buying more of her basics from the likes of Aldi and Amazon.

During the last reporting season, subdued trends were evident across the consumer space. There was a general softening in trading conditions and further pressure on margins, despite some clearance driven sales strength in some categories in May and June.

But retailing conditions are expected to remain challenged into Christmas, as the squeeze on real incomes intensifies. Another headwind came on 1 July, when headline electricity prices increased by 16% to 20% in NSW and Queensland. This further intensified pressure on the consumer as it came so soon after the 4% to 6% cost increases occurring across health care, education and childcare - all this against a backdrop of real wages experiencing negative growth.

Debt to income ratios are also very high. Anecdotally, many have underestimated their 'cost of living' with up to 50% of mortgage holders reporting they have zero savings.

Clearly, the consumer is 'the risk' in the Australian economy, which leads us to think that the traditional seasonal 17% retail spending lift (experienced every November/December) could be under threat this year.

We had an inkling of this when many stocks in the Consumer Discretionary sector reported reasonable results, but were sold off because of concerns about the consumer and, also, the entry of Amazon. JB Hi-Fi and Super Retail, for example, had strong results, but were sold down. Correspondingly, we are underweight the Retail sector in our client portfolios.

Frustration with the government is another issue because of rising utilities bills, rising private health insurance premiums (and the cost of health care generally), inadequate transport infrastructure and slow telecom services.

Rising energy costs aren't just affecting consumers, they are also eating into corporate profit margins, which highlights the importance of focusing on energy efficiency, especially in the manufacturing and construction materials sectors.

## Important ESG themes

Two other key themes to emerge during the last reporting season were the abnormally high turnover of chief executives and the growing emphasis placed on culture within listed corporate entities.

Both issues fall under the remit of ESG – environmental, social and governance. Ausbil integrates ESG factors to make better informed investment decisions.

Turnover of chief executives and chief financial officers has been dramatic this year and very high by international standards. The average tenure of an Australian CEO was 4.3 years last year, but we are certain it is lower again this year.

There is a greater focus on STI's and LTI's (short term and long term incentives) as corporate Australia finally gets the message that short term bonuses are meant to reward extraordinary performance, rather than be a standard part of an executive's salary.

Clearly, executives should only get bonuses when they beat expectations and objectives. Importantly, bonuses should not be viewed as a given part of fixed turn-up-to-work pay.

Elsewhere, our dedicated internal ESG research team highlighted that companies are increasingly talking about culture and staff engagement, which we regard as positive given that many corporate scandals and failures in the past have partly been related to questionable culture. In addition, culture can be a key positive value driver and is often an integral part of profitability improvements.

In our experience, major cultural transformations can be particularly good at unlocking value. It is important for investors to identify early signs of cultural transformation, both positive and negative.

The impact from ESG insights on individual stocks varies, but ultimately it is tied to Ausbil's investment philosophy that earnings and earnings revisions drive share prices and also that we have a preference to invest in companies with sustainable earnings and quality management. Sometimes ESG insights can result in adjustment to earnings forecasts and at other times it can impact our conviction about a company's management or strategy. Ausbil believes ESG factors, particularly changes in momentum in ESG performance, can serve as good lead indicators of earnings sustainability as well as be a proxy for management quality.

In the last reporting season, we believe 44% of the companies we analysed had net overall positive momentum on ESG factors, while 33% were neutral and 24% negative. This is in line with what we would expect, whereby the majority of companies should be improving.



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