Reviving animal spirits key to boosting top line growth

The current reporting season represents one of the most important events in the corporate calendar. Around 150 of the companies in the ASX200 will report their full year result for the twelve months to June.

Consensus expectations point to a corporate sector that remains beset by subdued revenue conditions. Analysts are forecasting this group of companies to achieve revenue growth of less than five per cent per annum in each of the next three years, which represents the most pessimistic revenue outlook in over a decade.

The prospect of weak top line growth is consistent with evidence that trading conditions remain difficult and that animal spirits are dormant across most sectors of the economy.

In an environment where revenue growth is anaemic, the corporate sector continues to engage in restructuring, selling off under-performing assets and cost cutting to boost profitability and cash flows. Indeed, analysts are forecasting earnings per share to achieve robust average growth of over 7 per cent per annum over the next three years.

This is a far cry from the double digit growth expectations of the credit boom era, but is more sustainable thanks to the fact that capital structures remain conservative, with many CFOs still cautious about lifting gearing; the aggregate leverage ratio for the 150 companies remains well below the credit boom peak.

The new capital discipline is being reflected in weakness of business investment. Much to the Reserve Bank's frustration, there is little sign of a handover in growth from mining capex to the non-mining sector. The looming risk facing the economy is the imminent investment cliff in the mining and energy sectors, particularly as the construction of the last LNG trains approach completion.

But the Reserve Bank's timid approach to monetary policy has done little to encourage entrepreneurial risk taking in the non-mining sectors.

The new capital discipline is helping to boost the corporate sector's free cash flow and enabling companies to cater to investors' strong appetite for income. The companies reporting in August are expected to pay out over $15 billion in dividends, which will be a welcome source of income to shareholders, particularly older Australians that rely on dividend income to fund their retirement. This group is increasingly becoming an important and influential investor clientele in the market.

Although the Reserve Bank continues to encourage the corporate sector to take on more risk, most companies remain reluctant to invest in new projects, lift gearing or hire new workers as long as difficult trading conditions and revenue headwinds persist.

The most effective way for the Reserve Bank to revive animal spirits is to ease policy further which would boost expectations of nominal GDP and flow through to stronger top line growth.

While the Reserve Bank Governor, Glenn Stevens, is right to point out that Australia avoided the worst of the financial crisis, the economy has been stuck in a nominal recession for the past two years.

Christina and David Romer, financial economists from the University of California, argue that at times in its history, the Federal Reserve has under-estimated the power of monetary policy, which they believe contributed to the Great Depression and Great Inflation of the 1970s.

If the Reserve Bank continues to under-estimate the power of monetary policy to raise the corporate sector's appetite for risk and revive animal spirits, the cost and capital discipline that promises to be a feature of companies' full year results this month, will become the new normal for many reporting seasons to come.

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Charts underpinning the analysis and references cited are available on request.

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