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HD **PacBrands, Reject Shop prompt downgrade fears**

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PROFIT downgrades by Pacific Brands and The Reject Shop yesterday have triggered fears of a late "confession season" rush, as retailers get hit by post-budget consumer blues.

Socks and jocks maker PacBrands and discount variety retailer The Reject Shop both blamed unseasonably warm weather and the collapse in consumer sentiment, now at a similar level to the nation's last recession in 1991, for the deterioration in the short-term outlook.

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PacBrands slashed its 2014 guidance for earnings before interest and tax by up to 24 per cent from $105 million to a range of $90m-$93m, while The Reject Shop indicated an expected net profit slump of up to 19 per cent, down from a projected range of $17m-$18m to $14.5m-$15.5m.

Goldman Sachsequity strategist Matthew Ross said it was "surprising" there had not been more downgrades in the May confession season. "But we're starting to get some more now among the retailers because of the warmer weather and post-budget sentiment falling away quite aggressively." The month of May is generally the peak period for earnings downgrades. On average, about 13 per cent of companies in the ASX 200 downgrade consensus annual earnings forecasts by more than 5 per cent during the month.

Equity strategists said the main profit-sapping factors in 2014 have been the marked decline in consumer sentiment, the relatively strong dollar, and the falling iron ore price.

Overcapacity and declining rates of growth in China have seen the iron ore price crash by 30 per cent from its 2013 average of $US135 to $US94 per tonne.

The share prices of the resources industry giants — Rio Tinto (90 per cent reliant on iron ore production), BHP Billiton (more than 50 per cent) and Fortescue Metals (100 per cent) — adjust according to short-term movements in commodity prices.

With the dollar lower than last year, UBSequity strategist David Cassidy predicted that stronger mining industry profits would Continued on Page 18 Continued from Page 17 drive earnings growth in the "low-double digits" for the overall market, followed by 6 per cent growth in 2015.

Mr Cassidy said discretionary retail and mining stocks were most vulnerable to earnings downgrades in the current environment.

While the David Jones share price was held up by the takeover bid from Woolworths of South Africa, he said Myer ticked all the boxes for vulnerability to a downgrade.

In a recent note, Commonwealth Bank equity strategist Tim Rocks set down his top eight picks for potential downgrades to consensus earnings forecasts.

Coca-Cola Amatil, Treasury Wine Estates and Crown Resorts featured in the consumer category, along with Fortescue and fixtures and fittings distributor GWA Group in materials, Toll Holdings in transport, Cochlear in healthcare and QBE in the financial sector.

While Coke recently downgraded 2014 earnings guidance, Mr Rocks said there was more to come, and Treasury needed a strong finish to the financial year to avoid a downgrade.

James Packer’s Crown was at risk due to soft economic conditions in Melbourne and Perth, Toll was vulnerable to weak volumes and competitive pricing, and Cochlear’s earnings were skewed to the second half and was relying on new product launches to meet profit forecasts.

As for Fortescue, a big June quarter was needed to meet its 2014 profit target, and QBE, even with benign catastrophe claims and recently maintained earnings guidance, was vulnerable to another writedown of its North American **business**.

GWA, with a large skew in its earnings to the second half, was also vulnerable to the recent deterioration in sentiment.

This was also an important factor for the overall market, according to Goldman’s Mr Ross, because most downgrades occurred in the second half.

Over the last decade, 51 per cent of earnings reported by the ASX 200 came in the December to June period.

The pattern, however, was broken last year, when the figure fell below 50 per cent.

In 2014, the market’s consensus is that it will jump back up to 53 per cent. “That’s a reasonably strong acceleration,” Mr Ross said.

Bank of America Merrill Lynch said in a note it was coming to the view that 2015 earnings estimates were too optimistic.

“Consumer sentiment is a key input into projected growth, and unless we see a rebound in sentiment there could be material downgrades ahead,” **equity** strategist Josh Kirkwood said.“Our biggest concern for 2014 is the implied margin expansion for industrials, excluding the banks.”

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