Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Markets Are Down, but Earnings Are Not... Yet

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The equity markets have had a terrible first half of 2022, with the MSCI World Index down over 20% in U.S. dollars (USD), the worst start to the year in over 50 years. The bizarre element is that the fall has all been down to derating, as earnings have not yet been hit. The earnings estimates for 2022 and 2023 are both up slightly, meaning that the 12-months forward earnings number is up 5% this year as it benefits from the increasing weight of the higher 2023 estimate as the year progresses.

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The derating is arguably less bizarre given the extreme multiple at the start of the year, which at 19.3x forward earnings was 36% above the average between 2003 and 2019, the 17-year period between the bursting of the tech bubble and the pandemic—during which the multiple never even reached 17x. The derating has taken the multiple down to 14.6x, only 3% above the 2003-19 average. This has clearly reduced the multiple risk from here, shifting our concern to the prospects for earnings.

Unfortunately, there are plenty of grounds to be anxious about earnings, even if inflation helps revenue growth, at least in nominal terms. The major threat in the short term is the prospect of an economic slowdown or recession. Central banks are attempting to counter inflation by dampening demand through higher rates. They are hoping to calibrate their rate rises to achieve a soft landing, and economic forecasts seem to think that this is achievable, with the Organization for Economic Cooperation and Development (OECD) predicting

1-2% growth for the USA and the euro area for 2023, with inflation falling and unemployment only rising marginally. The issue is that monetary policy can be analogous to trying to shift a brick by pulling on an elastic band—there is no effect until suddenly the central bank, along with the economy as a whole, gets a brick in the face. What is clear is that there are no signs of any risk of downturn in the current earnings numbers, given the continued robustness of the estimates.

The risk to earnings is raised further by the current record level of margins, with the MSCI World Index forward EBIT[1] margin edging up further to 16.7% this year, as against a 13.3% average and a 15.2% peak in the 2003-19 period. It seems that the excess demand is allowing companies to pass on even more than the rise in their input costs, be it through inflation (raising prices), 'shrinkflation' (reducing product sizes) or 'skimpflation' (trimming the level of services).

Any end to shortages, or worse still a shift to excess supply, could end this phase of generalised pricing power, with more commoditised companies suffering, while genuine pricing power holds up better. In the longer term, there could be further pressures on earnings, be they from rises in interest costs, the need to build more resilient supply chains, companies paying for the negative externalities they create, and even potentially from higher corporate tax rates as governments look to repair their finances.

The Global Financial Crisis of 2008-9 provides an interesting precedent. The market peaked in October 2007. The first phase of the market fall was a drop of 15% over the next eight months to summer 2008, even though forward earnings rose, as the market derated—a clear parallel to the 2022 experience so far. It was only in the second half of 2008 that the earnings started to fall sharply, along with a further erosion in multiples, to arrive at the market trough another eight months later in early 2009.

Whatever happens from here in 2022-23 will not be a repeat of 2008-9. However, the market's earnings are distinctly vulnerable given their current elevated level and the probable economic slowdown. Our focus on compounders, with recurring revenues and pricing power, should mean that the portfolio's earnings are more robust than those of the market, as was shown in 2008-9 and more recently in the first half of 2020 during the COVID-19 crisis. Given that earnings are the major risk from here, after the significant derating that has already happened, it arguably makes sense to minimise earnings risk from here by owning compounders.

[1] Earnings Before Interest and Taxation

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DEFINITIONS

Earnings Before Interest and Taxation (EBIT) is essentially net income with interest and taxes added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

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The **MSCI World Net Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the index is listed in U.S. dollars and assumes reinvestment of net dividends. The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

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