

### Global Equity Observer

# Multiples Are Down, Risks Are Not

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The good news about equities is that there are only two ways to lose money – falling earnings or falling multiples. A year ago, it was the multiples that worried us most. After the markets' bull run in 2017, the MSCI World Index passed 17x the next 12 months (NTM) earnings,<sup>1</sup> implying that markets were pricing in the improbable upside scenario of synchronized growth everywhere... and threatening considerable downside if things did not go quite according to plan. By contrast, 2019 starts with the MSCI World Index on 13.4x forward consensus estimates, 14% lower than the 20-year average price-earnings (P/E) ratio of 15.5x, and 20% below a year ago.<sup>2</sup> As a result, our primary fears have moved from multiples to earnings.

Our generic fear about forward earnings estimates remain – the fact that they are guesses about lies. The guesses are because the sell-side is persistently over-optimistic, by an average of 8% one-year forward, slightly higher than the 7% earnings growth expected for the MSCI World Index in 2019.<sup>3</sup> The lies are down to the gaping gap between the 'adjusted' earnings used to power consensus numbers (and management pay) and the actual IFRS/GAAP<sup>4</sup> number at the bottom of the profit and loss statement. Over the last three years, \$600 billion has disappeared between the adjusted and actual earnings totals in

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“Our primary fears have moved from multiples to earnings”

<sup>1</sup> Source: FactSet, as of 31 December 2018.

<sup>2</sup> Source: FactSet, as of 31 December 2018.

<sup>3</sup> Source: FactSet, Morgan Stanley Investment Management, as of 31 December 2018.

<sup>4</sup> IFRS = International Financial Reporting Standards; GAAP = Generally Accepted Accounting Principles.

the U.S. alone, overstating earnings there by an average of 21%.<sup>5</sup> Our more specific anxiety is fed by the fact that it is only on the leveraged earnings metric that markets look cheap. Looking at forward enterprise value (EV)/EBITDA<sup>6</sup> rather than P/E, the discount to the historic average disappears, and the market is on a slightly higher multiple (9.2x versus 9.0x) than it was in 2003, when the P/E ratio was at a lofty 17.6x.<sup>7</sup> Lower corporate taxes have helped, but so has the sharp increase in leverage, of which we discuss further later in the piece. Looking at EV/sales, the MSCI World Index is 1.8x, still 16% above its 20-year average.<sup>8</sup> The combination of an expensive market on sales with a 'cheap' market on earnings reflects the really high profitability at present, particularly in the U.S., where all the drivers look fairly maxed out in favour of profits at present, be it fat margins, low tax rates, high leverage or low interest rates.

We have no greater insight than anyone else on whether the expected earnings growth for 2019 will be delivered, or even exceeded, but we do have opinions (as usual) on the key variables to watch. The current China slowdown is an earnings risk, particularly for cyclical companies, and the extent (and success) of the gathering reflation is crucial. Even if the reflation does happen, and is successful, earnings could be soft in the first part of the year until it takes effect. As mentioned above, U.S. margins are very high, and while elements of this look structural, given the emergence of lucrative platform businesses and the way the country's political system has systematically advantaged capital against labour and consumers over the last four decades, tight labour markets and tariff impacts may cause margin issues for those without pricing power.

Leaving aside the tail-risks, such as a full trade war, utter paralysis of the U.S. government, Mid-East conflict or a collapse of the euro, one thing that would definitely cause a margin squeeze would be a significant slowdown in the U.S., or a further slowdown in Europe. The U.S. recovery is now very long in the tooth, and while recoveries do not just die of old age, the change at the U.S. Federal Reserve (the Fed) may be an extra cause for concern. It is still early days, but Jay Powell seems more interested in the state of the real economy than the exact level of the equity markets or the fate of anyone outside the U.S. who chooses to hitch their currencies to the U.S. dollar – i.e., emerging markets. He may, therefore, continue to tighten via a combination of interest rates and unwinding quantitative easing until he sees weakness in the U.S. economy. He will back off at that point, but this may be too late for markets.

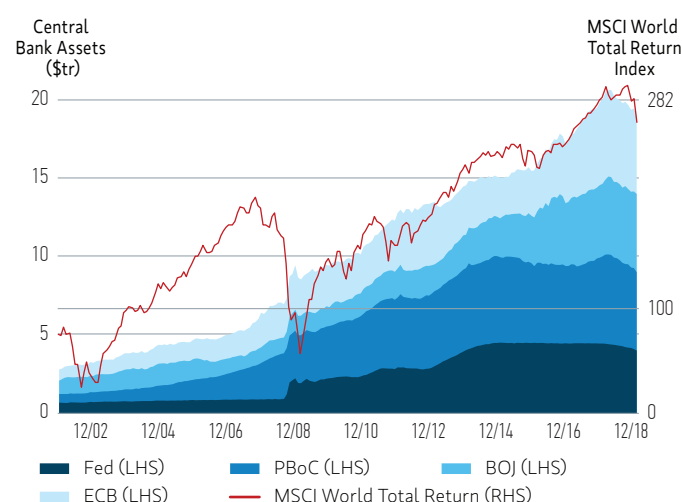
2018 has ended with the combined balance sheets of the four major central banks – the Fed, the People's Bank of China, the European Central Bank and the Bank of Japan – finally

shrinking after the massive build post the Global Financial Crisis (GFC). This means that the world is now in a liquidity squeeze, combining (depending on the geographic bloc) shrinking central bank balance sheets and tightening interest rates. It is precisely the opposite combination that drove up asset prices (and consequent leveraging up) since the nadir of 2009.

“Potentially falling earnings and a liquidity squeeze could be a truly toxic one for asset prices”

#### DISPLAY 1:

#### Central Banks Balance Sheet vs. MSCI World Total Return Index



Source: Morgan Stanley Investment Management, FactSet/MSCI.

Our concern is that the combination of potentially falling earnings and a liquidity squeeze could be a truly toxic one for asset prices. We mentioned that we were unclear whether earnings estimates would be met this year, but we are clear that the world is an asymmetric place, with earnings downsides in bad times far higher than the upsides in good times. This is often forgotten, as is the fact that the asymmetry is magnified by leverage – and there is more leverage than ever, particularly in the U.S. corporate debt market. Corporate America as a whole is not inexpert at leveraging itself up at the wrong time, most spectacularly, just before the GFC last time round. Given the scale of corporate leverage now and – more particularly – the component of high yield or near-high yield (or as we prefer to call it, given that the interest rates are not that high, junk or near-junk), Corporate America has to be right that earnings will hold up.

<sup>5</sup> Source: FactSet, Morgan Stanley Investment Management, as of 31 December 2018.

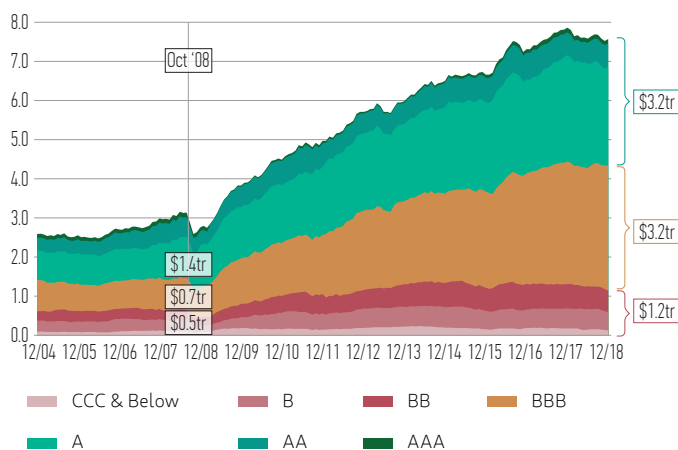
<sup>6</sup> EBITDA = Earnings before interest, taxes, depreciation and amortization.

<sup>7</sup> Source: FactSet, as of 31 December 2018.

<sup>8</sup> Source: FactSet, as of 31 December 2018.

## DISPLAY 2:

## Components of U.S. Corporate Debt



Source: Morgan Stanley Investment Management, FactSet/ICE BofAML Indexes.

We worry in particular about the outlook for near-junk, i.e. BBB. This has been at the epicentre of the buildup of corporate debt, ballooning from \$0.7 trillion in October 2008 to the current c. \$3 trillion.<sup>9</sup> Moreover, the component of near junk (BBB) and actual junk (BB, B, and CCC and below) has increased from 46% of the U.S. corporate bond market in October 2008 to 58% currently,<sup>10</sup> so the quality of the overall corporate bond market has clearly deteriorated. If U.S. earnings do fall significantly, then there could be significant downgrades from BBB to junk.

We do not think the currently quiescent so-called high-yield market is pricing in such an outcome. In that event, the equity market is sure to hear about it – big problems in the credit market invariably mean big problems in the equity market, especially as they would have a common cause: falling earnings and too much debt.

In this uncertain and acutely asymmetric world, we would continue to advocate owning compounders. The combination of recurring revenue and pricing power should protect revenues

“A combination of recurring revenue and pricing power should protect revenues and margins in a downturn, preserving earnings”

and margins, respectively, in a downturn, preserving earnings. They are also likely to be insulated from any financial distress if the corporate bond markets have a seizure, given the lower operational and financial leverage. The soft markets of the fourth quarter have deflated the portfolio's multiples a little, with the estimated 2019 free cash flow yield now over 5%, reducing the absolute downside risk.<sup>11</sup>

<sup>9</sup> Source: FactSet, as of 31 December 2018.

<sup>10</sup> Source: FactSet, as of 31 December 2018.

<sup>11</sup> Source: Morgan Stanley Investment Management, as of 31 December 2018.

## RISK CONSIDERATIONS

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect **global franchise companies** and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. Stocks of **small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing

in **emerging market** countries are greater than risks associated with investments in foreign developed markets. **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **Option writing strategy.** Writing call options involves the risk that the Portfolio may be required to sell the underlying security or instrument (or settle in cash an amount of equal value) at a disadvantageous price or below the market price of such underlying security or instrument, at the time the option is exercised. As the writer of a call option, the Portfolio forgoes, during the option's life, the opportunity to profit from increases in the market value of the underlying security or instrument covering the option above the sum of the premium and the exercise price, but retains the risk of loss should the price of the underlying security or instrument decline. Additionally, the Portfolio's call option writing strategy may not fully protect it against declines in the value of the market. There are special risks associated with uncovered option writing which expose the Portfolio to potentially significant loss.



**DEFINITIONS**

**Free cash flow yield (Next 12 months)** is a financial ratio that measures a company's operating free cash flow minus its capital expenditures per share and dividing by its price per share. Free cash flow yield ratio is calculated by using the underlying securities of the fund. **Price/earnings (P/E)** is the price of a stock divided by its earning per share for the past 12 months. Sometimes called the multiple, P/E gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying, and therefore the more earnings growth they are expecting.

**INDEX INFORMATION**

The **MSCI World 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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