THE TUG-OF-WAR BETWEEN EARNINGS PER SHARE AND P/ES

A tug-of-war is currently going on in equity markets, between deteriorating earnings fundamentals on one side and expanding valuations—what investors are willing to pay for those earnings—on the other. For the time being, valuations are winning and markets are grinding higher. How long can this last? The current Q2 earnings season may be pivotal in providing the answer.

We take a cautious stance on equities and one of the main planks is the view that corporate earnings growth potential in the medium term is muted, and too-aggressive market expectations need to adjust lower. Following the first-quarter earnings season, it seemed the adjustment to expectations that started in late 2018 had largely run its course. However, it now seems that reports of the downgrade cycle’s death have been—if not greatly then at least somewhat—exaggerated, or were made too early. As Exhibit 1 shows, after earnings revision ratios (ERRs—the ratio of analysts raising company-level EPS forecasts to those cutting them) rose back toward neutral territory and even moved briefly positive in the U.S., they have started to roll over again in the last few weeks.
The most likely culprit behind this renewed weakness is the rekindling in early May of the U.S.-China trade spat, which has been depressing global trade and corporate confidence. These now seem to be feeding through into declining earnings estimates—which have been falling faster outside the U.S. Even in the U.S., they are now within striking distance of negative territory: 2019 EPS growth forecasts for U.S. equities are now 2.5%, down from around 4% at the start of Q2. For the MSCI ACWI Index, 2019 growth estimates are around 3%, down from nearly 5% during the same period. And growth expectations in the U.S. are boosted by financials, whose earnings may come under further pressure in an environment of central bank rate cuts; ex financials, 2019 EPS growth is now expected to be just 1.5%. Looking out to 2020 forecasts, for some time we have been flagging these as too high. Now they, too, are finally beginning to fall, but remain in the range of 10%-11% both for the U.S. and globally. That seems aggressive, especially since roughly half of that growth is expected to come from margin expansion.

How do you reconcile these negative earnings trends with still relatively robust GDP readings? It is useful to bear in mind that the stock market is not the economy and that stocks are more exposed to areas of current economic weakness. Much recent global economic data shows a dichotomy between weak manufacturing and robust service sector activity. In the U.S., for instance, manufacturing accounts for over one-third of the S&P 500 market capitalization but only 11% of the U.S. economy’s GDP. Conversely, the service sector is underrepresented in the stock market relative to its importance in the economy.

The damage to activity from weak trade seems to be more pronounced outside than inside the U.S. In the U.S., large-cap equities are much more export-exposed than the wider economy, which may not be good news for U.S. equities overall, but they are still less exposed than most other major stock markets, such as Europe, Japan and the emerging markets. From a relative standpoint, this suggests U.S. equities offer a degree of defensiveness against an uncertain trade outlook and supports our preference for the U.S. among equity markets.

Against this background, recent solid equity market returns have been driven by rising P/E ratios, built on expectations for a fresh round of monetary stimulus from central banks. The S&P 500 Index’s 12-month forward P/E is back above 17x (closer to 18x when adjusted for, in our view, overly optimistic EPS forecasts) vs. a 30-year average of around 15.5x. Valuations outside the U.S. continue to be less stretched, with the MSCI ACWI’s

**EXHIBIT 1: GLOBAL EARNINGS REVISIONS ARE ROLLING OVER AGAIN**

Earnings revisions ratios (shown here as the percentage of all analyst earnings revisions that are upgrades) have rolled over into negative territory in recent weeks, after recovering towards neutral during Q2. The renewed downgrades, likely driven by the manufacturing and trade slump due to China-U.S. tensions, will probably be a headwind to expanding equity valuations.
12-month forward P/E around 15.5x, a touch above its long-run average. While these multiples are stretched rather than crazy, the question is how much higher they can be driven by looser policy alone. There clearly is a whiff in current market action of the TINA (“there is no alternative”) trade from earlier in this cycle—the idea that with central banks driving yields to unpalatably low levels across asset classes, equities may well be the least unpalatable choice. From a purely theoretic standpoint, current risk-free rates across the world would already support P/E levels much higher than those seen during this cycle. (Taken to the extreme, with zero percent discount rates, theoretical fair-value P/E would be infinite. Clearly this didn’t work so well in Japan and Europe.) So an extra, say, 50 basis points in cuts from the Federal Reserve theoretically should not make much of a difference. And equities’ grind higher could easily fall prey to a number of potential risks, such as a rebound in inflation arresting central bank easing or geopolitical risks (trade, Iran) further hitting the growth outlook.

Rate cuts may well sustain investors’ enthusiasm for equities for a while longer, but eventually equities’ direction should be driven by the earnings trajectory from here. And it is on this subject that the current Q2 reporting season may prove pivotal—but not because of earnings beats or misses (analysts have long expected Q2 and Q3 earnings to be weak, and companies are likely to solidly beat these low expectations, as per usual). Of more importance will be whether companies’ commentary about their outlook will justify the sharp growth pickup projected from 4Q19 onwards that is currently embedded in earnings forecasts. If not, and if forecasts continue their current slide, U.S. earnings growth for 2019 could quickly end up close to zero. That would likely make it much harder for investors to justify higher multiples.

**ASSET CLASS IMPLICATIONS**

Given full valuations, and a subdued earnings growth outlook with risks to the downside, we see limited near-term upside potential for equities. At the same time, we continue to see only mildly elevated recession risk, and recognize the potential for proactive easing in monetary policy to limit market downside for now. As such, we maintain a cautious—rather than outright negative—stance on equities in our multi-asset portfolios. We continue to favor allocating our risk budgets toward carry assets, taking risk in high yield corporate credit, in particular.

**EXHIBIT 2: U.S. EARNINGS FORECASTS—IS A REACCELERATION FROM 4Q19 REALISTIC?**

Current U.S. earnings forecasts are embedding expectations for a strong acceleration in earnings, driven by both topline and margin expansion from Q419 onwards. This seems aggressive. The current Q2 earnings season should provide important clues about how much U.S. earnings forecasts will have to be cut.

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