Global Equity Observer: Reckoning Deferred

By: Bruno Paulson | May 8, 2023

London - It was a strong quarter for markets, with the MSCI World Index in positive territory all quarter and finishing up 8%, on top of the 10% rise in Q4 2022. The market was led by the *growthier* sectors that suffered last year — Information Technology, Consumer Discretionary and Communication Services. But even Banks held up reasonably well despite the assorted failures, off only 4% in the quarter.

Performance in Q1 was driven by a re-rating, as the forward earnings multiple rose by over one turn while forward earnings were flat.

So where does that leave us?

The market now looks far from cheap, with the forward multiple of 16.2 times 14% above the 2003-2019 average, though perceptions may be skewed by the bubbly 20 times multiples of 2020-2021. In addition, the earnings that lie behind that multiple, and especially the margins, still look high. The sell side expects modest earnings growth of 2% in 2023 before a return to 10% growth in 2024. And the expected forward margins of 16.1% are still within 50 basis points (bps) of the all-time highs, and 80 bps above the pre-COVID peak.

Given this, and a healthy multiple on these elevated earnings, it is very difficult to argue that the market is pricing in any significant economic slowdown. Which is worrying if you believe that the current economic robustness could be only temporary, and that the economic reckoning may well have merely been deferred rather than avoided.

First the good news

It is true that there was good economic news in Q1, outside the banking sector at least. China bounced back post Q4's COVID spike, while the warm winter eased natural gas prices in Europe and helped U.S. economic activity. Accordingly, 2023 GDP growth forecasts rose, from 0.3% to 1% in the U.S. and from -0.6% to 0% in Germany.

Even in the banking sector, it looks like March's banking scare has been largely contained, though with costs for the AT1 (Additional Tier 1 bonds) market and U.S. regional bank lending. 2023 is not 2008. Banks are better capitalized, more liquid and — with the possible exception of those below the $250 billion asset threshold in the U.S. — better regulated.

Inflation and interest rates

The flip side of the good news on today's economic activity is that the inflation threat remains. Wages are still rising, in nominal terms at least, and companies are still pushing up prices, protecting their margins. Goods pricing pressures are easing, with 0% goods inflation in the U.S. in February, as the physical economy is recovering from the COVID supply chain disruptions. But the services sector, which is more linked to wages, saw prices up 7%.

Despite continuing inflationary pressures, the market's expectations for U.S. rates have dropped dramatically, with the December 2023 forecast for U.S. rates falling 150 basis points in a few days after the demise of Silicon Valley Bank. While volatile, bond prices currently suggest U.S. rates will begin falling later this year.

It is possible that this comes about through an "immaculate disinflation" as inflation falls back without economic damage. But it is more probable that the bond market is forecasting a sharp economic slowdown, which then requires an easing by the Federal Reserve. Despite this, the equity market reacted very positively to the falling rates expectations.

Reasons to be less cheerful

There are indeed reasons for pessimism about the U.S. economy later in the year. Leading indicators suggest caution, such as lending standards that were tightening even before the regional banking issues, low confidence among small businesses and falling expectations for consumer confidence. There has been a near 500 bps rise in rates, and some of the impacts come with lags. For instance, mortgage issuance has declined very sharply, but housing starts and construction employment have yet to suffer.

Bloomberg's survey of economists show 65% are now predicting a U.S. recession, though generally not a severe one, and 2024 GDP growth forecasts are falling as 2023 numbers rise. In terms of corporate earnings, this looks like a reckoning deferred, but a reckoning nonetheless.

Equity market complacency

As leading economists squabble about whether the Fed has done too much or not enough, we do not claim to have particular insight on what is going to happen in this unpredictable year. But we can say with some confidence that the equity market looks complacent, pricing a scenario at the happier end of the potential range of outcomes.

After all, the market is trading on high multiples on close to peak margins in the face of a very possible — or even probable — U.S.

recession. Equities are also showing normal levels of volatility, in contrast to very elevated volatility in the bond market.

Bottom line: Given the vulnerability of currently high earnings to an economic slowdown, we would argue that quality is a relative safe haven. Companies with proven long-term track records of pricing power and recurring revenues are likely to show more resilient earnings than the general market, if and when the downturn comes, and history shows that resilience may be rewarded by outperformance.

So far, the market's 2022 decline and 2023 recovery have all been about de-rating and then a partial re-rating, with earnings roughly flat — meaning that quality companies have not been able to differentiate themselves. The real test will come when the market's earnings fall, perhaps later this year, which should allow quality companies to shine.

Basis point is a unit of measure, equal to one hundredth of a percentage point, used in finance to describe the percentage change in the value or rate of a financial instrument.

Index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

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.

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