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IS THE GLOBAL EARNINGS RECESSION CONCLUDING?

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The nominal post-GFC recovery has been the weakest in history as debt demographics and disruptive technology offset the impact of record fiscal and monetary stimulus, and this has been a contributing factor to the earnings recession in most regional sharemarkets over the past year, but not the only one. Matt Sherwood, Perpetual's Head of Investment Strategy, Multi Asset says that contracting earnings primarily reflected lower commodity prices but ex-resource EPS growth is positive in all developed regions, albeit anaemic relative to history. Recent data around the globe has been consistent with growth and while better US and Chinese growth in the second half of the year should lift 2016 profits, it will remain well below long-run averages. In contrast, European and Japanese corporations are struggling with higher currencies, whereas the depreciation of the US dollar and a stabilisation of commodity prices have postponed the pain for the emerging market. Despite this, with risk premiums already low, economic growth is needed to boost profits and broken economic models, waning investment and slowing growth suggest that prospects here remain low.

KEY TAKEOUTS

- Valuation expansion has contributed the entire market return since mid-2011 overall, and also in the vast majority of markets. The difference between share price trends and earnings delivery has largely been due to investors pricing a 'return to normal', which is something that regional central banks have not been able to engineer, despite the adoption of highly unconventional policy. Indeed, earnings have grown in excess of inflation in only three of the largest 31 markets since 2011 and with P/E ratios around post-GFC highs and corporate cost-out near exhaustion, firms need economic growth and revenue growth to continue the near-five year recovery.
- For a third consecutive year, US GDP looks to have started the year on a weak footing as a widening trade deficit, soft consumer spending, declining capex and a protracted inventory draw down all point to very weak growth in the March quarter. However, manufacturing and service sector PMIs have risen and US job creation remains upbeat which suggest the growth slide should reverse soon. Meanwhile, sequential growth in China has also picked up supported by counter-cyclical policy easing, continued property market recovery and some commodity restocking. Nevertheless, its too soon to declare that the earnings recession is over in all regions – things look better in the US, but central bank policy in Europe and Japan appears increasingly deflationary and the prospect for strong economic recovery in the EM is still hard to fathom.

INTRODUCTION

Investors normally assume a positive relationship between share prices and corporate earnings growth, but it is not always the case. Historically we have seen periods where share prices rise and earnings growth decline, but these are normally short-lived and at the beginning and the end of the business cycle as was seen in 1975, 82, 91, 2003 and 2009. It is extremely unusual that the trend extends beyond one year, yet since 2011 developed market share prices have risen +53% from their 2011 trough whereas EPS is down -8% over the corresponding period. This difference is unusually large and unusually long, but it has diminished over the past year.

ONE MISSING INGREDIENT

There is no doubt that the tremendous global equity rally over the past four years has been a relief to investors but it has had one important ingredient missing and that has been that there's been scant evidence of sustained earnings growth. Of the 31 countries listed in Chart 1, valuations have risen in all 31 of them since August 2011, but prices have increased in only 21 markets, total earnings have risen in only seven and earnings growth has exceeded inflation in only three markets (namely, the US, Japan and Ireland). Whilst Ireland's +107% increase has been the most dramatic it followed a -90% decline between 2008 and 2011, so that still leaves the market's EPS -79.3% below its 2007 peak.

A 'RETURN TO NORMAL' HASN'T MATERIALISED

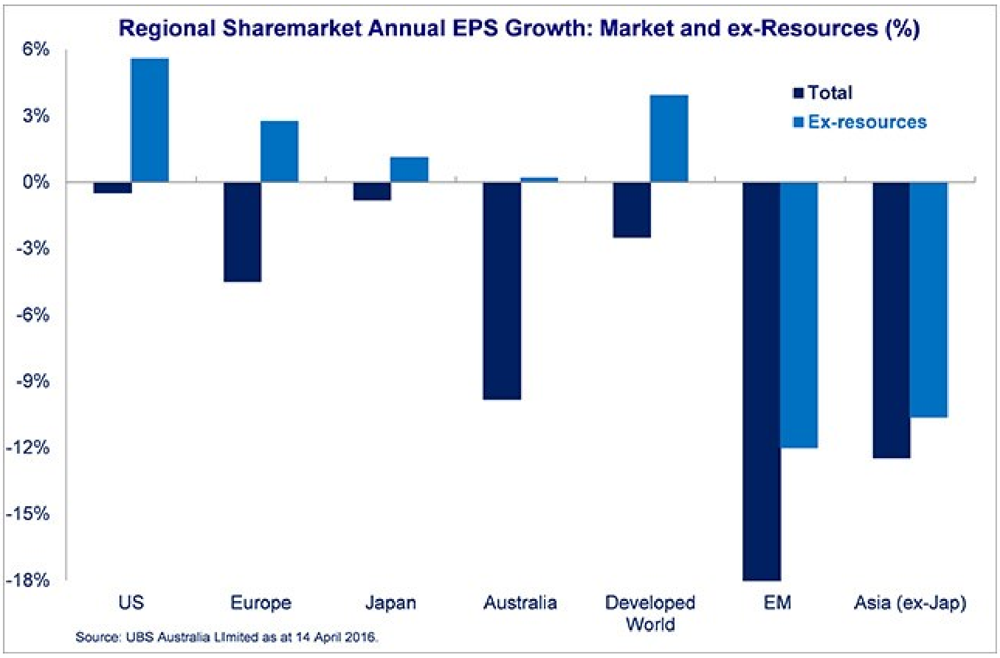
Overall, valuation expansion has contributed the entire market return since mid-2011 and also in the vast majority of markets. The difference between share price trends and earnings delivery has largely been due to investors pricing a 'return to normal', which is something that regional central banks have not been able to engineer, despite the adoption of highly unconventional policy. This tells investors that EPS growth is essential to keep the near-five year market recovery alive and with cost cutting near exhaustion, this means revenue growth and economic growth is needed to boost corporate bottom lines.

CHART 1: ONLY THREE MARKETS HAVE GROWN EARNINGS ABOVE INFLATION SINCE 2011

NEGATIVE EPS - DRIVEN BY LOWER COMMODITY PRICES

One issue that has impinged EPS growth over the past year has been the downward trend in commodity prices, which hurt earnings in advanced economies and sparked recessions in numerous emerging markets. This sparked sizable EPS declines in regions with large resource exposures including Europe, Australia and the emerging markets. Interestingly, when the large resources losses are excluded, the remaining industrial sector EPS growth is positive in all advanced markets and less negative in the emerging markets (see Chart 2). However, relative to history, non-resource EPS growth is still low and corporations are clearly struggling as the world remains a weak place, cost out is close to exhaustion and margins are already beyond previous peaks and likely to decline if wages growth improves. In this world, what is good for the economy may be bad for corporates and financial markets.

CHART 2: POSITIVE DEVELOPED MARKET EPS EX- RESOURCES



A WEAK MARCH QUARTER, BUT...

Recent data around the world has been mixed but consistent with continued sub-trend economic growth. For the third consecutive year, US GDP looks to have started the year on a weak footing as a widening trade deficit, soft consumer spending, declining capex (which is now only replacing depreciated assets) and a protracted inventory draw down all point to very weak growth in the March quarter. However, this growth slide is likely to be short-lived with manufacturing and service sector PMIs improving and US job creation remains upbeat (although this suggests that the slide in labour productivity is set to continue). Meanwhile, sequential growth in China has also picked up supported by counter-cyclical policies easing, continued property market recovery and some commodity restocking. Elsewhere, headline inflation is very low reflecting commodity prices, but a slide deflation on core measures appears very unlikely, which should further support earnings growth.

SO WHAT'S NEXT?

Year to date earnings revisions by analysts have stabilised in the US and EM, which is to be expected given recently improving US economic data, the lower US dollar and a stabilisation in commodity price (in the case of the EM). A better macro outlook should enable the S&P 500 to grow earnings by around +4% in 2016, but corporate performance in other major regions is lessening convincing. Indeed, revisions have deteriorated markedly in Europe and Japan and EPS is likely to decline by about -5% in both regions. Meanwhile despite lower revisions, a weaker US dollar and higher commodity prices, the EM EPS recession is likely to continue in 2016 (although the contraction will decline to around -7%, after falling by -19% last year). Accordingly, it is probably too early to claim an end to the earnings recession in all regions, but some countries and regions are clearly more advanced than others in their cycle and commodity prices ceasing their decline will naturally improve overall listed company results and this could see the valuation recovery since mid-February extend further.

TWO KEY ISSUES

There are two key issues for investors. Firstly, while the US has the most optimistic earnings outlook, it is the market which also has the highest valuation with a forward PE ratio of 17x earnings which is considerably higher than Europe (14.9x), Japan (12.2x) and emerging markets (11.9x). Secondly, markets with more attractive valuations have larger macro risks – the growth pictures in Europe and Japan are clouded, currencies are moving higher and central bank policy appears increasingly deflationary. More importantly, the corporate sector in these regions over the past six years have clearly struggled to grow earnings in the absence of strong currency tailwinds, which have clearly reversed in recent months.

NEGATIVE RATES ARE JUST A SAVINGS TAX

The other factor weighing on Japanese and European earnings has been negative interest rate policy. If you are making a payment to any arm of government, whether it is the Treasury or a central bank, it is a tax and no country ever taxed its way to greatness. Europe once looked to Switzerland as the poster-boy of why negative rates can work. But these two areas are implementing negative rates for different reasons – the latter did it to lower its exchange rate, whereas the ECB did it primarily to boost credit growth as Europe is a closed economy which mostly trades with itself. Interestingly, Swiss banks raised housing rates to fund the tax payments to the central bank, and if this spread to broader Europe it would dampen growth and spark increased stress in the world's largest trading bloc and this could be a concern as ex-resource corporations there are struggling to grow earnings above nominal GDP.

IMPLICATION FOR INVESTORS

The earnings recession is concluding in some regions, but not in others. In the near-term, investors will be watching upcoming reporting seasons with a clear focus on any clues that the decline in old economy cyclicals (energy, materials and industrials) is stabilising and how this (and weaker financial markets) is impacting the performance of financials. On a region-by-region basis the key is where each market is in its earnings cycle – the US seems most advanced, followed by EM, whereas Europe and Japan seem to be deteriorating.

Better economic growth should be constructive for US earnings later this year. However, the outlook for Europe and the emerging markets seems more clouded whereas Japan faces the multi-headwinds of stalling growth, high debt, poor population profiles, a central bank who seems fresh out of ideas and a government with no political capital left to implement difficult reforms. Looking ahead, persistent Yen strength over the medium term will be just another factor weighing on Japanese EPS growth. Although this market has a very low valuation relative to the past 25 years, it appears to be a value trap, and investors could contend themselves that there is better growth and opportunities in other markets. Moreover, I think Japan is going to be the next major stress point for the global markets, unless Brexit gets there first.