Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

The Multiple's Gone. Are Earnings Next?

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At the start of 2022, we only had two worries about the equity market, but they were significant ones: the multiple and the earnings. In 2022, forward earnings held up reasonably well, up 4% for the MSCI World. The 18% fall in the index has been entirely down to a sharp derating in public markets, with the MSCI World forward earnings multiple falling from 19.3x to 15.0x times—in contrast to private markets, which have protected investors from volatility by failing to mark prices down.

AUTHOR

BRUNO PAULSON
Managing Director

This derating has been particularly concentrated in the more expensive, "growthier" companies, with communication services, consumer discretionary and information technology all falling over 30%. The combination of resilient earnings and this skewed derating has made 2022 a very unusual year, as quality has not provided the protection in a downturn that it did in the previous down years of 2008, 2011, 2015 and 2018, with the MSCI World Quality Index down 22% for the year, 400 basis points (bps) behind the wider index.

"It is striking that forward earnings estimates still look relatively healthy despite the prospect of the most predicted recession in history"

At the start of 2023, our two worries from 12 months ago have reduced to one and a bit. The fall in the MSCI World multiple to 15x, now only 5% above the 2003-19 average as against the 36% premium at the start of the year, suggests that the market is no longer clearly overvalued; though, of course, the multiple could fall below average levels if there is a major economic downturn. It is earnings that remain the major concern. Inflation should help top-line growth, in nominal terms at least, but the margins do look stretched, with the MSCI World forward EBIT (earnings before interest and taxes) margin at 16.3%, 100 bps above the pre-COVID peak and a full 300 bps ahead of the 2003-19 average. This is consistent with the world of excess demand we have been in, which has given all sorts of lower quality companies pricing power. Companies' earnings issues in this period have tended to be idiosyncratic, rather than due to systematic demand issues. Many have come from either the direct impacts of COVID-19, for instance in messing up their supply chains, or from the post-pandemic hangover, with former "COVID heroes"—beneficiaries of the virtual world of the pandemic—having to adjust to the return towards an IRL (in real life) world.

It is striking that bottom-up forward earnings estimates still look relatively healthy despite what has been described in various forums as the most predicted recession in history, with 2023 MSCI World earnings estimated to be 3% higher than 2022 despite the headwind from the strong dollar, and 36% above the pre-COVID 2019 level. Central banks, particularly in the U.S., are raising rates aggressively to deal with inflation by attempting to slow demand. There is discussion about exactly how far they need to go, weighing up the balance between slowing goods inflation and continuing wage rises, as well as arcane discussion of the lags in the shelter element of the U.S. inflation calculation. We are in no position to take a view on these intricacies as mighty economists face off against one another.

However, the basic fact remains that, even in the case of a successful soft landing, the consensus economic outlook is for 2023 growth to roughly grind to a halt in most Western economies. The impacts of central bank actions are already being felt in the more interest rate sensitive areas, notably housing, and consumers are facing an ugly squeeze on real incomes thanks to inflation, but labour markets remain tight, with U.S. unemployment still down at 3.5%, keeping upwards pressure on wages—and on central bank action. Forward-looking indicators have turned down, but most of the economic pain, and thus earnings pain, is still to come.

As the excess demand of 2021 and 2022 shifts towards excess supply in 2023, there is likely to be an earnings recession as margins fall from current peaks. Once again, the market will discover which companies have resilient earnings in tough times. Our bet, as ever, is that pricing power and recurring revenue, two of the key criteria for inclusion in our portfolios, will once again show their worth, as they did in the 2008-09 Financial Crisis and in the first half of 2020, during the early days of the pandemic. Compounders should continue to compound. The silver lining of the painful derating of 2022 is that any compounding is now coming on top of a lower multiple. Given that there are only two ways of losing money in equities—the earnings going away, or the multiple going away—owning a portfolio of resilient earnings at a reasonable multiple does seem a sensible approach in such uncertain times.

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DEFINITIONS

A basis point (bps) 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.

Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) is essentially net income with interest, taxes, depreciation, and amortization 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.

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 **MSCI World Quality Index** is an index that measures the performance of quality stocks in developed countries throughout the world. The index aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth and low financial leverage. The index includes reinvestment of dividends, net of foreign withholding taxes.

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