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Downunder Daily

Past an Inflection Point

It's now well appreciated that this equity market cycle has been driven predominantly by earnings, rather than valuations. The E, not PE, has moved markets (Exhibit 1 shows the picture for the global MSCI index). This is a critical point, in my view. In particular, it suggests that the key threat to the bull market is material downgrades to growth and earnings, rather than rising rates.

It's therefore worth noting that we have seen a turn in the revisions cycle for global growth. A few comments on this:

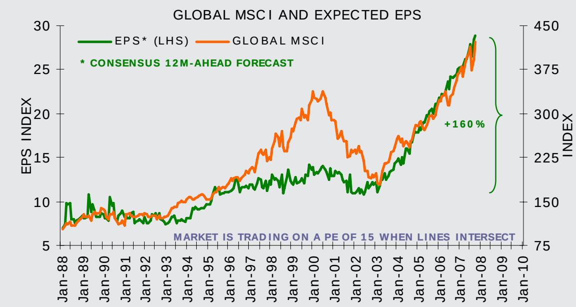
First, it seems that the global economy has passed an inflection point: After four years of persistent upgrades to global growth and earning forecasts, we are now seeing downgrades.

For now, those downgrades are fairly minor – and, more to the point, don't undermine the consensus view that global growth (and hence earnings) will continue to grow strongly next year. However, the risks clearly seem slanted to the downside, a point reflected in the IMF's assessment of the risks around its base-case global growth outlook (Exhibit 2).

Second, while the biggest downside risks surround the US, I also expect downgrades to forecasts outside the US. There has been a material tightening in monetary policy in other developed economies, now overlaid by a degree of credit tightening by lenders, as well as signs of housing markets approaching a peak in some European countries. Japan is also disappointing.

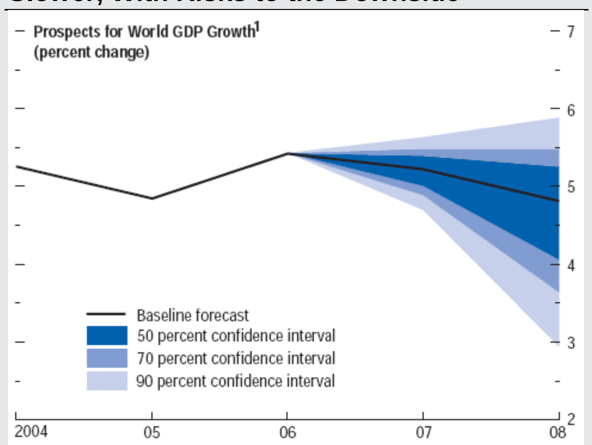
Third – and most importantly for investors – consensus earnings forecasts are seemingly oblivious to this shift in the economic outlook. While economists have shifted from upgrades to downgrades, EPS forecasts remain high and – remarkably – some are going higher for the out-years.

Exhibit 1
It's a Global Earnings Bull Market



Source: MSCI, IBES; Morgan Stanley Research

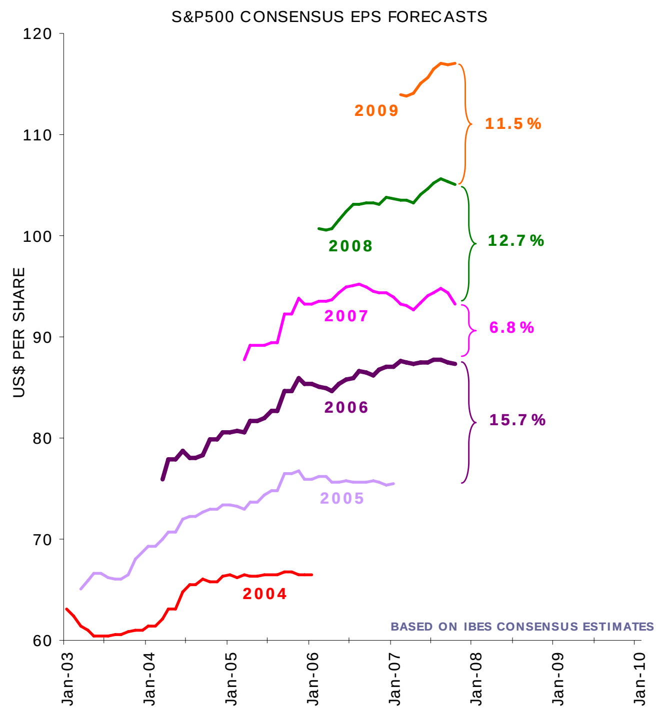
Exhibit 2
Slower, With Risks to the Downside



Source: IMF *World Economic Outlook*; Morgan Stanley Research

This is most apparent in the US, which is where the economic growth downgrades have been the most significant. Exhibit 3 shows the latest set of consensus forecasts for S&P 500 earnings per share. Analysts have scaled back their 2007 earnings forecasts. However, 2007 continues to be seen as an aberration, with double-digit earnings growth expected to resume in 2008 and 2009.

Exhibit 3
2007 Is Just a Hiccup

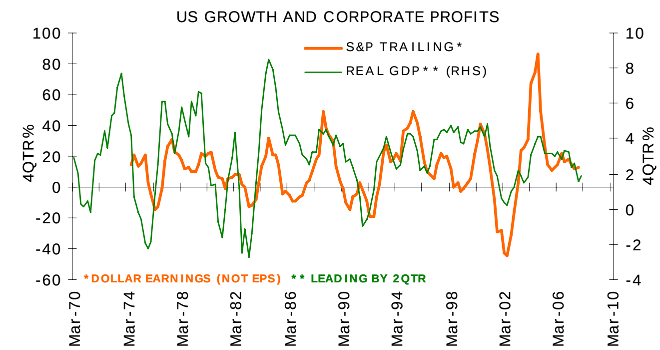


Source: IBES; Morgan Stanley

This looks remarkably optimistic. Earnings growth always slows when GDP slows. Exhibit 4 shows the link between GDP and S&P 500 earnings. There are times when the relationship breaks down – but those breaks are almost always because earnings growth is weaker than implied by GDP growth (such as in 1985 or 1999), not because earnings growth is stronger than implied by GDP.

Even after allowing for some extenuating factors – such as US$ weakness (which adds a translation luster to offshore-sourced earnings) and stock buy-backs (which can drive a wedge between EPS and earnings growth) – current consensus earnings forecasts look far too optimistic, in my view.

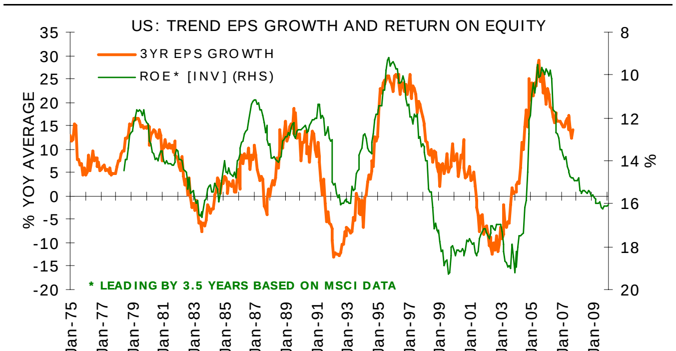
Exhibit 4
Slower Growth Slows Profits



Source: Standard & Poor's, BEA; Morgan Stanley Research

It is true, however, that earnings don't always drive markets. It may be that earnings could disappoint, but equities hold up due to an expansion in the PE ratio. It is possible to remain optimistic if you expect a soft landing. But in a hard landing, PE expansion never offsets the fall in earnings.

Exhibit 5
Mean Reversion Stays on Track



Source: MSCI; Morgan Stanley Research

There's one final bigger-picture point to note. I keep on insisting that markets are now in the midst of an earnings bubble (as opposed to the more usual PE bubble) – a view that implies not only that earnings are high, but that they will fall. The view that margins mean-revert has become a contentious point with some investors. As I've discussed before, I think there are powerful economic forces that point to margins mean-reverting, one of which is that abnormally high returns lead to increased competition, which depresses earnings growth – just as low returns destroy competition, leading to rising earnings. Exhibit 5 shows this process at work in the US. More to the point, it shows that the process continues to work now, as it has in the past.

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