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Downunder Daily

The Rise and Fall Of E

This will be an unusual bear market because, unusually, it is a deflating earnings bubble. Just as equity markets were led higher by earnings, they will be led lower by earnings. More to the point, just as equities appeared cheap throughout the boom, they may appear cheap throughout the bust.

Exhibit 1 illustrates the US story: It shows the S&P 500 index and consensus 12-month ahead EPS forecasts. The index is on a prospective PE of 15 when the two lines overlap. The late 1990s was a PE bubble; this cycle has been an earnings bubble.

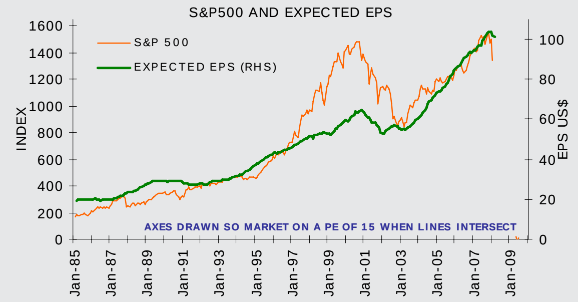
Of course, it's only a bubble if earnings fall. I think earnings do mean-revert, for reasons I've discussed in prior DuDs. Exhibit 2 is a (simple) guide to how big the fall may be: It shows real EPS and a long-term trend. EPS have fallen to below the trend in every recession since 1940. In the current cycle that would require a 42% fall from the late 2007 EPS peak. It's also worth noting that real EPS have fallen to virtually the same level in every recession since 1970. That level is 68% below the peak seen late last year.

There are a few points to note about a deflating earnings bubble:

First, never expect this sort of earnings decline to be forecast. In fact, never expect the sell side to forecast a decline, full stop. Exhibit 3 shows the full history of IBES consensus EPS forecasts for the S&P 500: The lowest growth ever forecast was 5.6%, expected amidst the TMT collapse. In fact, Exhibit 4 shows the secret of consensus sell-side forecasts: Take the trailing number and add a few percent. (The earnings line in Exhibit 4 is the IBES operating definition – 'earnings before bad stuff' – while the earnings forecast in Exhibit 2 is the headline reported.)

Exhibit 1

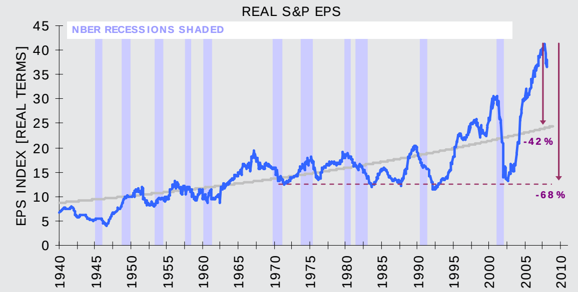
E-led on the Up; E-led on the Down



Source: Standard & Poor's; IBES; Morgan Stanley Research

Exhibit 2

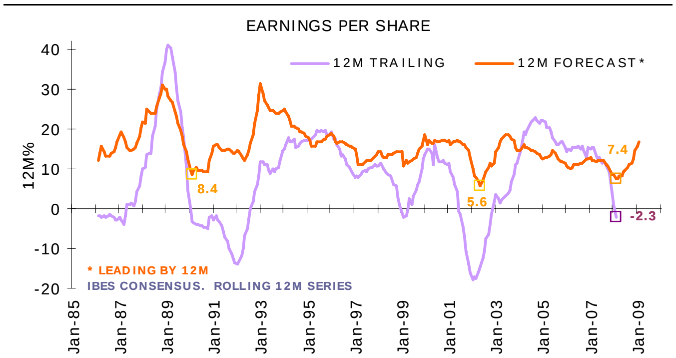
Quite a Way to Fall



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

There is, however, value in comparing the current earnings forecast with the forecast made a year ago. That is, whether the prospective E is rising or falling. Exhibit 5 shows the change in the prospective E, and shows how it's correlated with a cycle variable – in this case, the change in the Fed funds target. This relationship points to material further downgrades to forecast earnings.

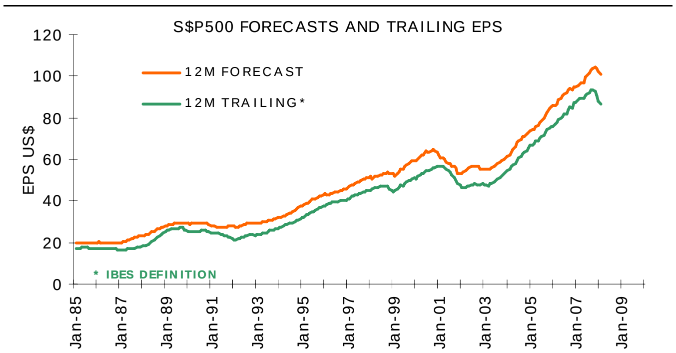
Exhibit 3
Never Forecast a Fall



Source: IBES; Morgan Stanley

Second, an earnings-led bear market is likely to be an incremental affair. Corporates will take time to lower their forecasts, and analysts will take time to follow. Whereas investors can quickly knock PE points off a share price, aggregate earnings estimates tend to move less rapidly.

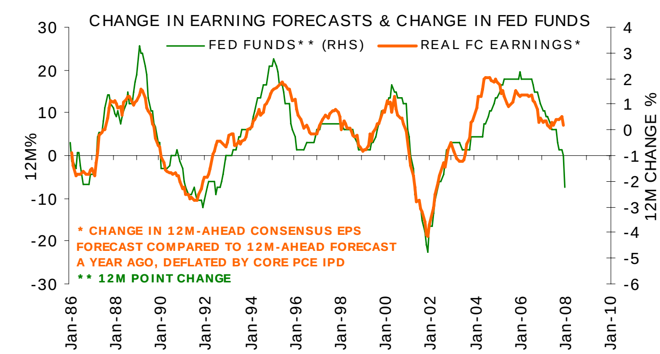
Exhibit 4
Take Trailing and Add a Few Percent



Source: IBES; Morgan Stanley Research

Third, the market will likely look cheap throughout the bear market – at least, cheap based on consensus earnings forecasts. That apparent cheapness will likely be the catalyst for periodic bear-market rallies. Those bear-market rallies will be triggered by signs of economic recovery – because if the economy does recover and the earnings forecasts are met, then the market really will be cheap. But as I discussed yesterday, I think it's too early to buy equities on that basis now; indeed, policy will probably be less successful than usual in reviving growth.

Exhibit 5
Follow the Fed

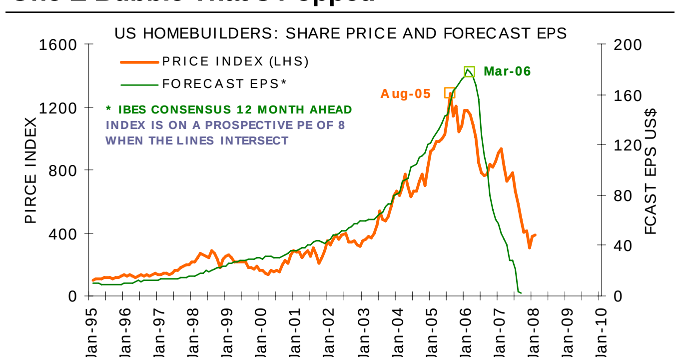


Source: Bloomberg, IBES; Morgan Stanley Research

Exhibit 6 illustrates these points with one earnings bubble that's already popped, US homebuilders. The chart is drawn so that the sector is on a prospective PE of 8 when the lines overlap. There was never a re-rating on the way, and the market was consistently cheap on the way down. It was only in the latter stages – as the 12 month ahead earnings collapsed – that the PE increased. But the index still fell: The PE increased because earnings fell faster than the price (index).

Homebuilders are deep cyclical, of course. But I think the broader market will follow a similar pattern: an extended bear market, with periodic bounces, led lower by declining earnings.

Exhibit 6
One E Bubble That's Popped



Source: Standard & Poor's, IBES, Morgan Stanley Research

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(as of January 31, 2008)

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Underweight/Sell	**346**	**15%**	**98**	**13%**	**28%**
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