Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Reckoning Deferred

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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 the fourth quarter of 2022. The market was led by the growthier sectors that suffered last year: information technology, consumer discretionary and communication services.

Even banks held up reasonably well despite the assorted failures, off only 4% in the quarter. The performance in the quarter was driven by a rerating, as the forward earnings multiple rose by over one point while forward earnings were flat.

So where does that leave us? The market now looks far from cheap, with the forward multiple of 16.2x at a level 14% above the 2003-19 average, though perceptions may be skewed by the bubbly near 20x multiples of 2020-21. 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. Bearing this in mind, it is very difficult to argue that the market is pricing in any significant economic slowdown, given a healthy multiple on these elevated earnings. This 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.

It is true that there was good economic news in Q1, outside the banking sector at least. China bounced back after the fourth quarter of 2022's COVID-19 spike, while the warm winter

eased natural gas prices in Europe and helped U.S. economic activity. The 2023 gross domestic product (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 contained, though with costs for the AT1 (Additional Tier 1 bonds) market and U.S. regional bank lending. And 2023 is not 2008: Banks are better capitalised, more liquid and, with the possible exception of those below the $250 billion asset threshold in the U.S., better regulated.

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-related supply chain disruptions, but the more wage-linked services sector saw prices up 7%.

Despite this continuing inflationary pressure, the market's expectations for U.S. interest rates have dropped dramatically, with the U.S. December 2023 rates forecast falling 150 bps in a few days with 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 U.S. Federal Reserve (Fed). Despite this, the equity market reacted very positively to the falling rates expectations.

There are indeed reasons for pessimism about the U.S. economy later in the year. Leading indicators, such as lending standards that were tightening even before the regional banking issues, low small business confidence and falling consumer confidence expectations, suggest caution. 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. In the Bloomberg survey, 65% of economists 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.

We do not claim to have particular insight on what is going to happen in this unpredictable year, as leading economists squabble about whether the Fed has done too much or not enough. 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 the very elevated volatility in the bond market.

Given the vulnerability of the currently high earnings to an economic slowdown, we would argue that quality is a relative safe haven. We maintain our view that 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 suggests that resilience will likely be rewarded by outperformance.
So far, the market's 2022 decline and 2023 recovery have all been about derating and then a partial rerating, 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.

Source for all earnings and valuations data in this report is FactSet, data as of March 2023.

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DEFINITIONS

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.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports.

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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