Current earnings development advises caution

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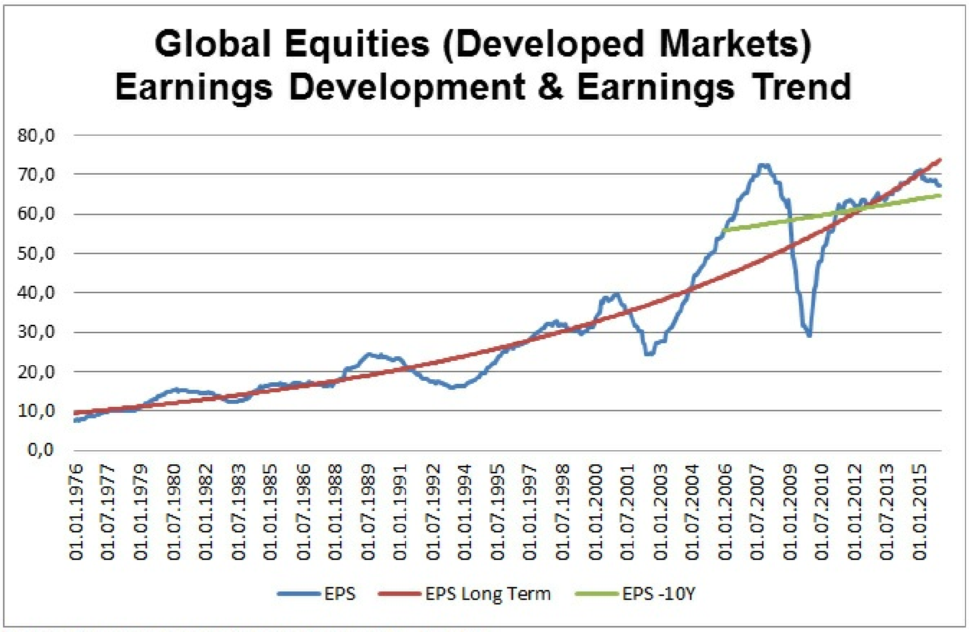
The international stock exchanges recorded a rather dismal start into the new year. The reasons cited most frequently were China and the declining oil price. A weaker Chinese economy will definitely register also on an international scale due to the mere size of the country. While a weaker oil price is beneficial to consumers, it does cause significant levels of stress in the energy sector as well as among banks that provide credit to the sector.

A factor that has hitherto been more or less disregarded is the general earnings situation of listed companies. Therefore we want to take a closer look at this topic in this article. Without earnings growth, there can be no sustainable rise in share prices.

Earnings cycle has peaked out

In the developed markets equity universe the earnings cycle peaked out in February 2015. Since then, earnings have been on a slow but steady decline.

This development is not limited to the energy sector. Even non-cyclical consumer goods have shown a weaker tendency for two years now. Only healthcare and the technology sector have so far been able to buck the trend.



EPS = Earnings per share (company earnings) – blue line
EPS long term = Earnings per share trend – red line
EPS – 10Y = Earnings per share, 10Y average – green line
Sources: Bloomberg, Thomson Reuters, own calculations

Current earnings trend advises caution

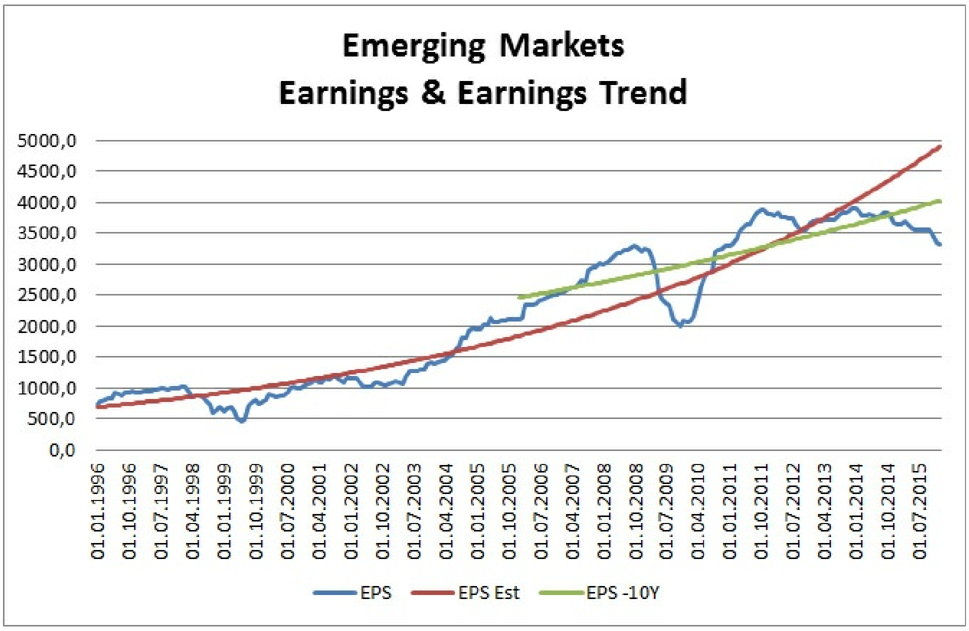
The long-term chart covering the past 40 years (blue line) shows the cyclical nature of the earnings development. The red line indicates the earnings trend over the entire period. Earnings have increased since the 1970s by an average of 5.6%. The green line illustrates the earnings trend over the past ten years, which is significantly flatter. In this less extensive analysis, earnings have only increased by an average of 1.9%, with five MSCI sectors (energy, commodities, financials, telecoms, and utilities) recording no growth at all over that period.

We can see that whenever earnings have fallen clearly below the trend line, a recession ensued, or indeed a recession was already occurring. In the past 40 years this has been the case four (!) times.

The current earnings development definitely advises caution: as long as the negative trend prevails, the international stock exchanges will be finding it difficult to rise.

The earnings trend in the emerging market has been negative for a while

In the emerging markets the earnings situation has been negative for a while, which explains the weak performance of this equity class. While earnings recovered after the financial crisis, they peaked out back in 2011 and have not reached that level again since then; in fact, earnings have been on the decline since that time. This can also be explained by the composition of the equity indices. The index weighting of sectors displaying relative strength such as the technology sector and healthcare is low to non-existent. On the other hand, energy, commodities, and financials command very strong weightings.



EPS = Earnings per share (company earnings) – blue line
EPS Est = Earnings per share trend – red line
EPS – 10Y = Earnings per share, 10Y average – green line
Sources: Bloomberg, Thomson Reuters, own calculations

Falling earnings are a negative indicator for equities. As long as no stabilisation or trend reversal is in sight, the pressure on the markets will not let up.

As explained above, earnings have increased by an average of 5.6% in the past. At +6.3%, the MSCI World index has recorded a slightly better performance. This is due to the fact that the price-earnings ratio has widened from 13.7x to 18.0x, which can be explained by the decline in yields and which therefore cannot be repeated. By adding dividends, we get a total historical performance of 9.1% p.a.

New reality: lower total performance expected

The average earnings increase of 5.6% is pretty much in line with global, nominal GDP growth over the past 40 years. Assuming a generally weaker growth rate and lower rates of inflation in the future, company earnings should increase more slowly as well. This means we will hardly see a repeat-performance of past gains. With regard to the extent, we can only speculate: perhaps in the future an expected total performance (price increases and dividends) of five to six percent will be the new reality.

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