Weekly Digest
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Investec
Wealth & Investment

The Professional Advisers' weekly insight into world stock markets

Earnings Season

There are two main components to the value of a company – the earnings that it generates and the multiple that investors are willing to apply to those earnings. In its most basic form that is expressed in the price/earnings ratio (P/E). The P/E can fluctuate quite a bit, depending on influences ranging from the yield on cash and government bonds to the amount of risk that investors are willing to take. This is the classic "voting machine" as described by Benjamin Graham. But if you look at markets (and the individual companies of which they are comprised) over the long term, the P/E mean reverts, and no markets can hang on to gains made purely on the basis of being more highly valued. This is where the earnings (and the dividends that are paid from them) come in. This is what Graham described as the "weighing machine". In the long term a company's valuation will be determined by the value that it creates and the cash it returns to shareholders.

I have discussed this subject in the past, often in the context of lacklustre earnings growth. At the beginning of 2011, the MSCI World Index was forecast by analysts to generate 113 cents of earnings. The current forecast for 2017 is 122 cents, just 8% higher. But the index itself has risen 51% since then, which means the P/E has risen from around 11x to almost 16x (NB – you might see different P/E numbers elsewhere as different accounting items can be added or subtracted depending on the view of the compiler. However, the underlying re-rating will be the same as long as the treatment of these items is consistent).

The story is the same pretty much everywhere. In the UK, over the same period (according to Bloomberg data), the P/E has risen from 13x to 17x, with eps 12.5% lower; in Europe from 10.4x to 15.7x, with eps forecasts 22% lower; the P/E of Emerging Markets is actually little changed over the period (although has recovered well from its 2011 lows during the euro zone crisis), but eps forecasts remain almost 20% lower. The notable exceptions are Japan and the US. Earnings in Japan are up an impressive 86%, so the fact that the P/E is unchanged has been of little hindrance to a market that has risen over 70%. But the laurels go to the US, where earnings forecasts have risen 74%, which, combined with a rerating from 13.5x to 18.75x, has delivered a capital return of 95%. (I note that these numbers don't compute exactly, but I am captive to my data supplier and I believe they at least give a fair view of the underlying trends).

We have been suggesting for a couple of years that further substantial progress for equities would require more support from earnings, but this has not proven to be the case, and we have been pleasantly surprised. Equity performance has outstripped earnings growth, mainly owing to the uncertain background and the influence that has had in sending bond yields lower, especially when combined with the effects of continued Quantitative Easing. However, we might finally be approaching the point where those earnings really do need to come through. This is because some central banks are considering tighter (or perhaps less loose) monetary policy, as discussed in the Digest two weeks ago. So what is the current outlook for earnings?

The good news is that earnings are growing, and look set to continue to do so through 2018. Consensus estimates compiled by Citigroup point towards 14.4% global earnings growth this year, which, remarkably, is an increase from the 13% growth forecast back in January, and 10.6% in 2018. I say "remarkably", because earnings upgrades over the course of a year are a rare event, generally occurring in only one year in every four. The last time we saw net upgrades was in 2010 when the world was crawling out of the pits of the financial crisis and pessimism was rife at the start of year. Some markets are faring better than others within that average. The UK's 2017 growth forecast has slipped from 22.3% to 19.6%, for example. Remember that much of that growth was predicated on the recovery in the oil price and the translation benefits derived from weaker sterling. The soggy oil price and the pound's recovery (or should that be the dollar's weakness?) have undermined reported profits to some degree.

The big winner is Europe (ex-UK), where earnings growth forecasts are up from 12.7% to 19.6% for 2017. This has been driven by a combination of domestic recovery and increased exports as global trade has recovered. Perhaps the only caveat here is that we are beginning to see the odd downgrade based on currency movements. The euro has risen almost 10% against the dollar so far this year, which is going to be a drag on translated profits for multinational companies. Still, as long as the underlying business is robust, this should not prove disastrous.

Whether we like it or not, we are in for a long summer of parsing every syllable of the pronouncements of Mrs Yellen and Messrs Draghi, Carney and Kuroda. The annual Jackson Hole Economic Symposium (August 24-26) is already becoming a focal event, especially now that Mr Draghi has said he will be speaking there. The market battle between higher earnings and potentially higher interest rates will be running for a while yet. This raises the prospect of attacks of nerves over the summer, but we continue to believe that they will not develop into anything more serious on the basis of current evidence. Finally, the odd man out among Allen, Compton, Edrich and Warner is Compton. The others are all names of former England Test cricket captains. This week, which cartoon character was originally called Oswald?

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Head of Investment Strategy

Last Week's Economic Highlights

UK – Unemployment declined further to 4.5% and the 3-month average for earnings growth firmed to 2.0%, so a slightly better set of data, but not necessarily enough to create an MPC majority for raising rates, especially as member Ben Broadbent said he was not ready to raise yet.

US – The overall CPI was 0.0% m/m in Jun, below the +0.1% consensus. Core inflation was a bit tamer than expected again unchanged at 1.7%. Headline inflation has also slowed in the last few months, as the boost from oil prices has faded.

Europe – Industrial Production across the region grew 4% y/y, finally surpassing the level of September 2008, which bodes well for Q2 GDP Growth. Only Portugal and Greece failed to join the party, with France, Spain and Germany leading the way.

China – Strong data. Q2 GDP was +6.9% (consensus +6.8%), while June Industrial Production was +7.6% (+6.5%), Fixed Asset Investment +8.6% (+8.5%) and Retail Sales +11.0% (+10.6%). A conference of the PBoC stressed the need for more prudent financial regulation, diluting some of the positive impact of that numbers.

This Week's Forthcoming Events

UK	CPI % y/y
UK	Retail Sales (ex Auto Fuel) % y/y
UK	CBI Industrial Trends (20th-25th) % bal
UK	Public Borrowing (PSNB ex banks) GBP bn
UK	Output Prices (unadj.) % y/y
US	Empire State Survey index
US	Housing Starts k
US	Initial Claims k
EU	Consumer Sentiment index
EU	HICP % y/y
EU	ECB - Deposit Rate %

FTSE 100 Weekly Winners

Glencore	6.3%
Anglo American	6.3%
Antofagasta	5.3%
BHP Biliton	5.0%
BT Group	4.7%
Fresnillo	4.3%
Worldpay Group	4.2%

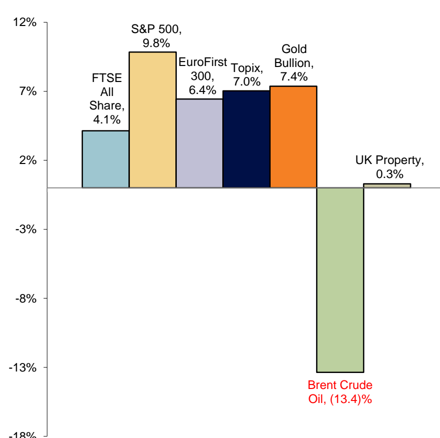
Source: FactSet

FTSE 100 Weekly Losers

Pearson	-7.3%
Marks and Spencer Group	-5.7%
Micro Focus International	-5.2%
Provident Financial	-4.9%
Paddy Power Betfair	-4.0%
Associated British Foods	-3.9%
Kingfisher	-3.6%

Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months

Source: FactSet

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