Global Earnings Cycle Provides Support Amidst Uncertainty

Our weekly view on asset allocation.

28 February 2022

Earnings Upgrade Cycle set to Continue

While equity markets remain on edge over the outlook for global inflation and more recently the Russia Ukraine situation, the robust global earnings picture continues to provide a degree of underlying support to the equity market outlook.

With US, European, and Australian earnings seasons now winding up, consensus earnings estimates have once again edged up over the past month.

Recent global results for the final quarter of 2021 show earnings growth for 2021 was very strong, in part due to easy comps driven by the onset of the pandemic in 2020, along with the strength of the global economic recovery.

Significantly slower growth is expected in 2022, with earnings comps tougher, economic growth slower, and cost pressures widespread. However, with global economic growth still expected to proceed at an above-average pace, we still see the prospect for the earnings upgrade cycle to extend in 2022.

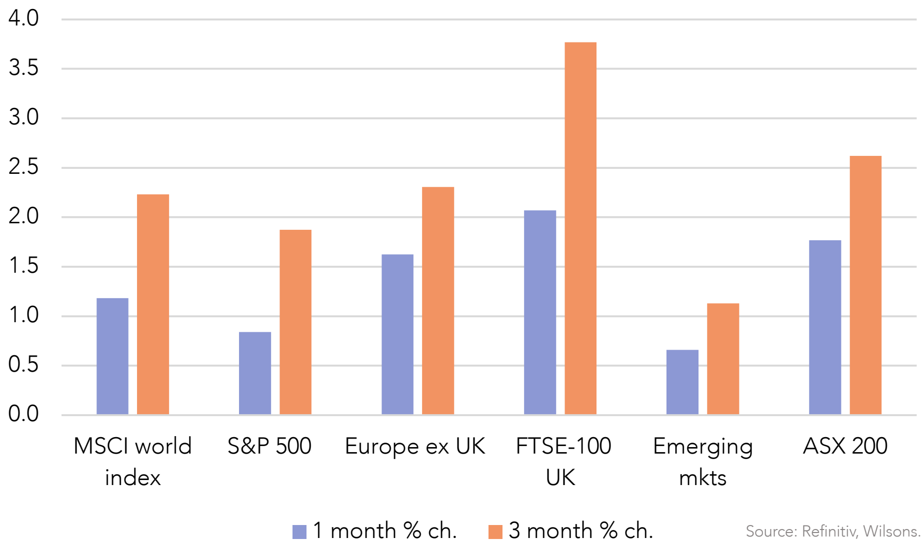
All major regions remain in upgrade mode

While all major regions are currently in upgrade mode (including Australia), the UK has had the strongest recent earnings momentum, followed by continental Europe. US earnings upgrades have slowed but are still positive despite the 12% price correction in the S&P500.

Indeed, the recent 4Q21 US earnings season has spurred the 20th consecutive monthly upgrade in US earnings 12-month forward estimates.

Growth for the fourth quarter looks like coming in around 30% year-on-year (YoY) compared to an estimate of 21% at December 31. US estimates for 2022 are factoring in much slower but still a solid 9% earnings growth.

Exhibit 1: Earnings upgrades in all regions with UK now leading the way



Source: Refinitiv, Wilsons.

US PE Contracts as Share Prices Fall, but Earnings Estimates Rise

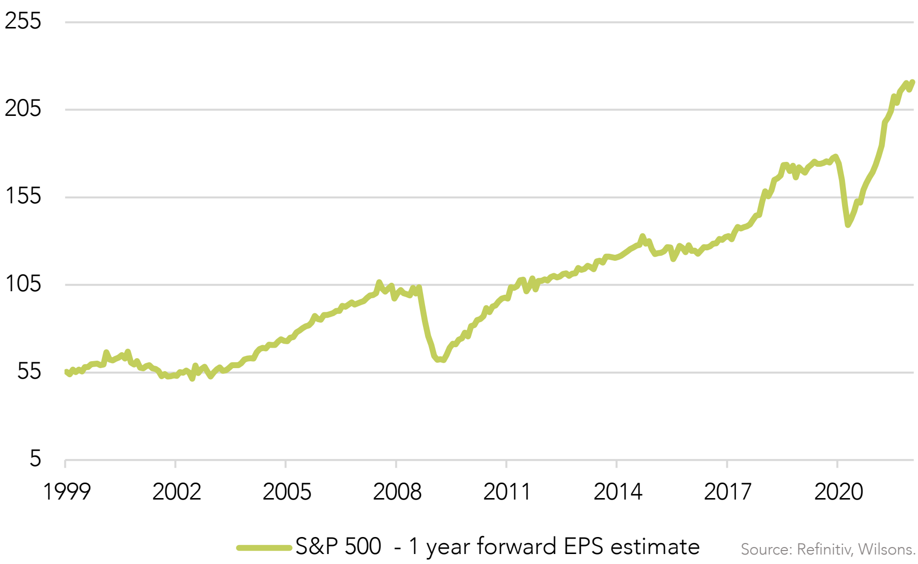
Higher earnings and lower share prices have seen the US 1 year forward PE multiple move down from 21.5x to 19.5x in the past 3 months. This is still not a cheap absolute multiple in either a global or historical context. However, we believe valuations are reasonable relative to interest rates and when the quality of the US mega caps is considered.

Indeed, US tech giants Microsoft (MSFT), Apple (AAPL), Amazon (AMZN), and Alphabet (GOOG - Google) all delivered very strong results, highlighting the quality and dominance of US large-cap tech despite the correction in the broader tech index.

Exhibit 2: The US PE has contracted though it remains high

Source: Refinitiv, Wilsons.

Exhibit 3: US earnings are now 24% ahead of pre-COVID levels



Source: Refinitiv, Wilsons.

The Russia/Ukraine Impact

Markets in Europe and the UK have so far been more resilient this year with less exposure to high multiple "growth stocks" and high leverage to economic recovery.

Clearly, the rapidly evolving Russian Ukraine situation poses risks for the earnings outlook for continental Europe, particularly via the impact on gas prices and gas supply with Russia a very significant source of supply.

The US and UK/EU will levy significant sanctions centered on banking and hi-tech exports, but they are unlikely to halt Russian energy exports as that would risk causing a recession in Europe.

Europe receives around 40% of its gas supplies and 25% oil supplies from Russia - so European leaders are unlikely to pull the energy sanction lever given the risk of recession that would imply. The current $100 Brent oil price is a high price but will not induce a recession. We would watch the European gas price and gas supply continuity closely.

We do see these events as at least a moderate headwind for the European market relative to the US, although we continue to like the energy-heavy UK equity market.

Sector Earnings Trends

At the global sector level, performance has followed earnings momentum recently, with energy delivering the best performance by a large margin followed by financials. While the IT sector has been the weakest price performer, earnings estimates continue to see upgrades in aggregate, which cautions against becoming too bearish.

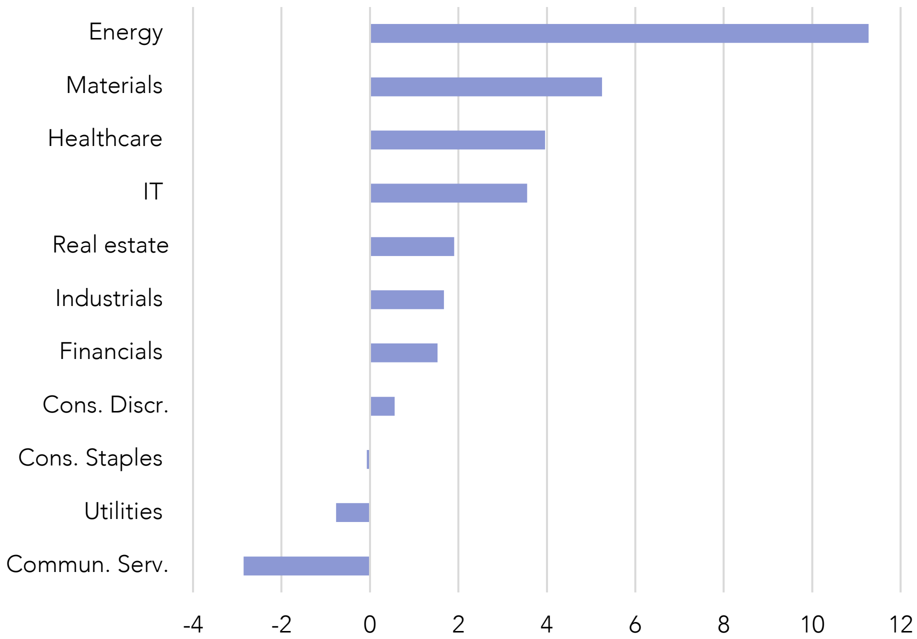
Aggregate earnings still defying cost pressure for now

Cost pressures remain a key area to watch, with US, Europe and local companies all calling out a significant inflationary pulse in terms of input and labour costs. While this has caused significant pressures for some companies, aggregate earnings are still coming through strongly with firm revenue lines driven by strong economic growth, and corporate price rises flowing through to buoyant profit outcomes.

Of course, while the ability of corporates to push through higher cost input prices is good for profits, it also means the global inflationary pulse is not about to disappear any time soon. We think inflation is close to hitting its absolute peak, but there is a risk that it comes down less than the market is currently expecting over the next year as corporates push through more price hikes and labour demands higher rates of compensation.

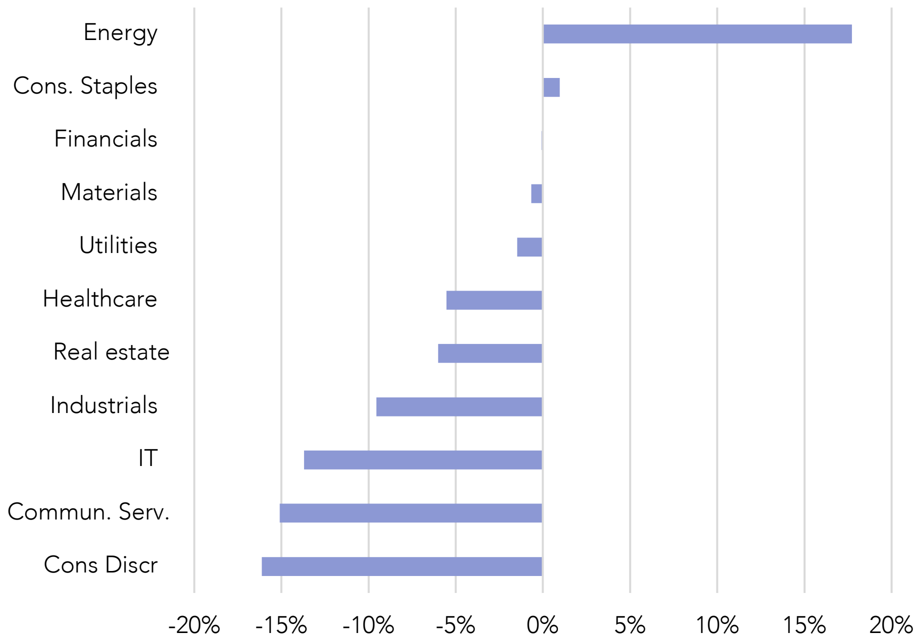
While the cost and pricing power cycles are a clear issue to monitor near-term, single-digit earnings growth estimates still look conservative given the robust base case economic outlook and we still see the upgrade cycle continuing as a central case. We continue with our long-standing call for an extended upgrade cycle though cost pressures and geopolitical risks are adding risk to the call.

Exhibit 4: The global energy sector is leading the global upgrade cycle - 3 month consensus earnings revision



Source: Refinitiv, Wilsons.

Exhibit 5: Energy leading share price performance. IT and IT-related have lagged recently - 3 month performance



Source: Refinitiv, Wilsons.

Earnings Remain a Bullish Support Despite Wall of Worry

The outlook for inflation and interest rates is of course critical, and the geopolitical situation in Europe is also raising the equity risk premium. However, a resilient global economy should drive the earnings cycle ahead over the next year.

The Russian invasion of Ukraine is a risk in terms of its potential to disrupt the economic cycle via energy market impacts (particularly in Europe). With our central case of strong economic growth driving good earnings growth, we still think equities can ultimately push higher over the balance of the year.

We stick to our view that more value/cyclical markets (Australia, UK, Emerging Markets) will have the edge over the coming year as growth remains above trend and interest rates grind higher. However, the large pullback in growth sectors - and the size of the fall in the US market overall - against solid aggregate earnings trends is bringing growth exposures back onto our radar.

Exhibit 6: Global equities - consensus valuation and earnings growth outlook

	PE (12 Mth expected EPS)	CY20 EPS growth	CY21 EPS growth	CY22 EPS growth
US	19.5	-14	51	9
Europe	15.4	-28	70	8
UK	12.2	-40	95	4
GEM	12.1	-13	57	6
Australia	16	-20	35	7

Source: Refinitiv, UBS

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Recommendation structure and other definitions

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Wilsons contact

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.com.au