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The impact of earnings recessions – where to now?

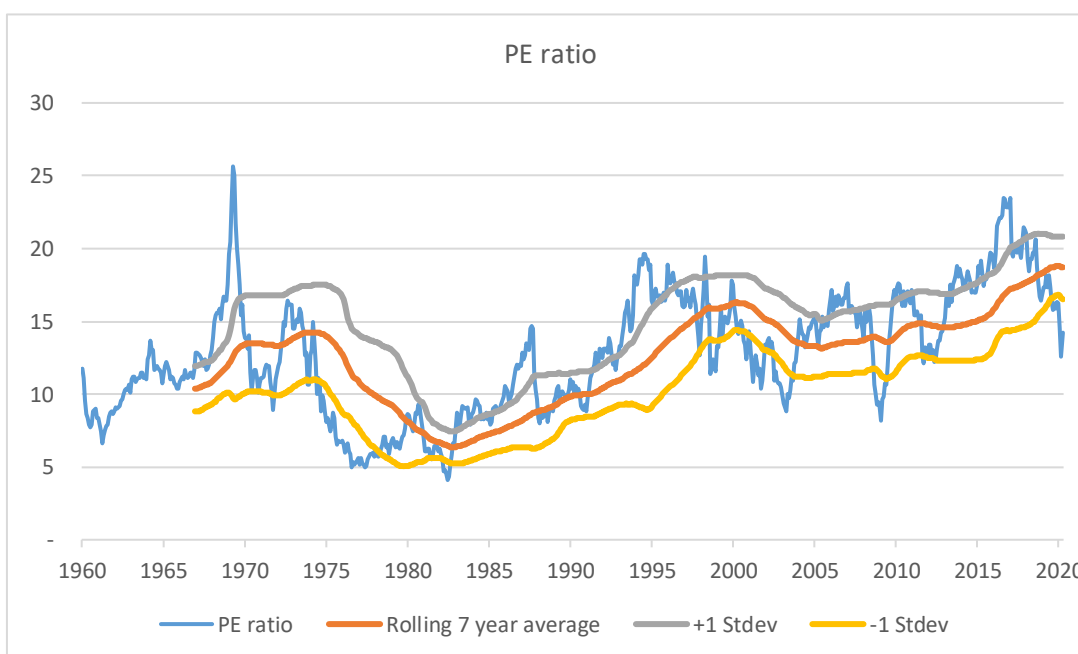
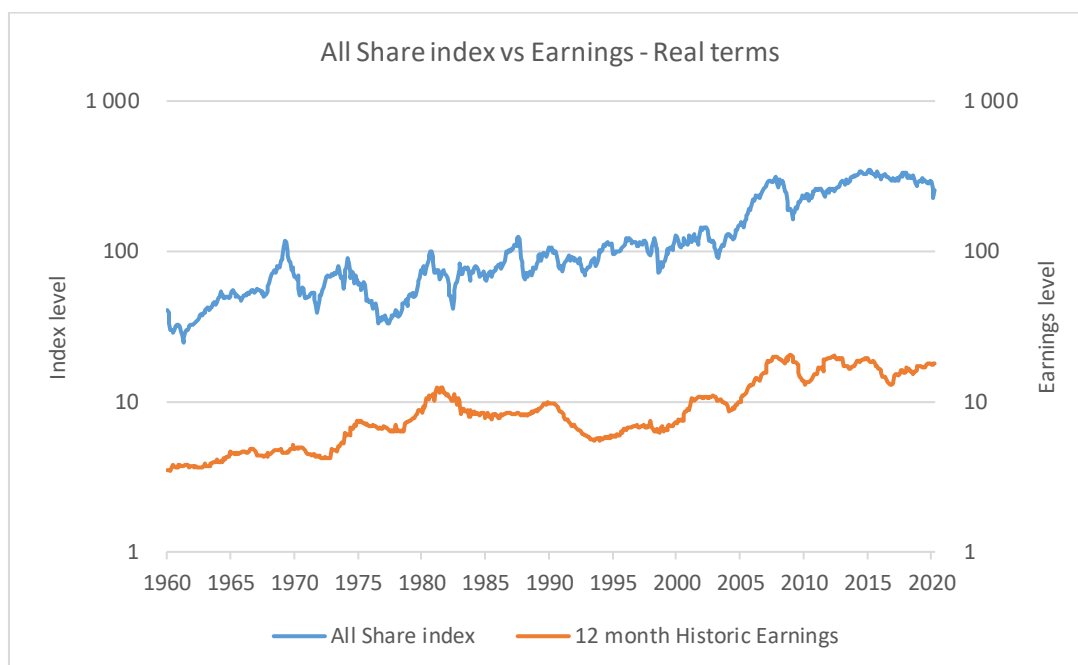
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Two elements dictate the level of the FTSE/JSE All Share Index, namely earnings and rating. Earnings can be adjusted for inflation to provide a more comparable analysis across generations. In this paper, we explore the impact of earnings “recessions” as a way of understanding market downside risk, historic time to recovery and the rating from which the market was able to recover.

Supporting information

Data is drawn from the IRESS database. Note that, for comparability purposes across different eras, we prefer to view data in real (inflation-adjusted) terms.

Data is similarly shown on a log scale, the implication of which is that the visual representation of a 20% movement in the time series back in 1960 looks the same as one today (see the graph below).



In the table above shows the rolling seven-year comparisons to accommodate the shift in discount rates over time and to approximate typical business cycles. However, comparisons over time should be circumspect given the changing nature of the constituents of the indices and accounting conventions.

Summary data

Numbers are not annualised. Latest data point is 30 April 2020.

Month of market peak	Month of market trough	% Fall (real)	Months (peak to trough)	Peak PE	Trough PE	Month of real earnings peak	Month of earnings trough	% Fall (real)	Months (peak to trough)
Jan-60	Apr-61	-39.8%	15	11.8	6.6	Earnings generally stayed flat / appreciated			
Apr-69	Oct-71	-64.5%	19	25.6	8.9	Dec-69	Feb-72	-19.3%	26
Mar-74	Aug-76	-63.4%	29	14.9	4.9	Dec-74	Aug-77	-15.0%	32
Oct-80	Jun-82	-58.2%	22	9.1	4.1	Jul-81	Oct-83	-36.0%	27
Aug-87	Feb-88	-47.0%	6	14.7	8.0	Aug-87	Apr-88	-4.4%	8
Jan-90	Jan-91	-30.0%	12	11.0	8.8	Nov-89	Jul-93	-44.2%	44
Apr-98	Aug-98	-41.9%	4	19.4	11.3	Dec-97	Jan-99	-14.1%	13
Mar-02	Apr-03	-38.2%	13	13.8	8.8	Nov-02	Jul-04	-17.6%	20
Oct-07	Feb-09	-47.7%	16	15.8	8.2	Sep-07	Feb-10	-37.0%	29
Feb-15	Feb-17	-15.7%	24	18.8	19.8	Jan-15	Nov-16	-33.3%	22
Apr-19	Mar-20	-24.0%	11	18.1	12.6	Nov-19	to date	-1.0%	5

Further observations

- The market achieved a low of 37 963 on 19 March 2020, representing a fall from the peak in April 2019 of 36.2%. However, the nature of the monthly representation above shows this fall as “only” 24.0%.
- The market recovered some 12% of its depreciation in the last two weeks of the month.
- From the low point to date (19 May 2020), the market is up 25.6%.
- In conventional terms, a recovery of more than 20% constitutes the beginning of a new bull market, which begs the question whether this has all been a storm in a teacup?

Closer examination of the data

- The obvious conclusion is that market falls tend to be further and faster than earnings fall due to the double impact of the reduction in market rating; the only exception in the data above being February 2015 to February 2017. This is also the period with the smallest market reduction, and the only period where the earnings trough preceded the market trough.
- One other notable point from the table above is that an earnings base reduction of around 35% would not be extreme in the context of the last 60 years.
- The average period between market and earnings trough is 12 months (excluding the last two periods), with extremes of 30 and 2 months. General market expectations are for significant falls in global and local earnings over at least the next 6 to 12 months.
- The average period in which the market peaks before real earnings peak is 4 months with a range of -4 to 9 months.

The market rating and forward earnings

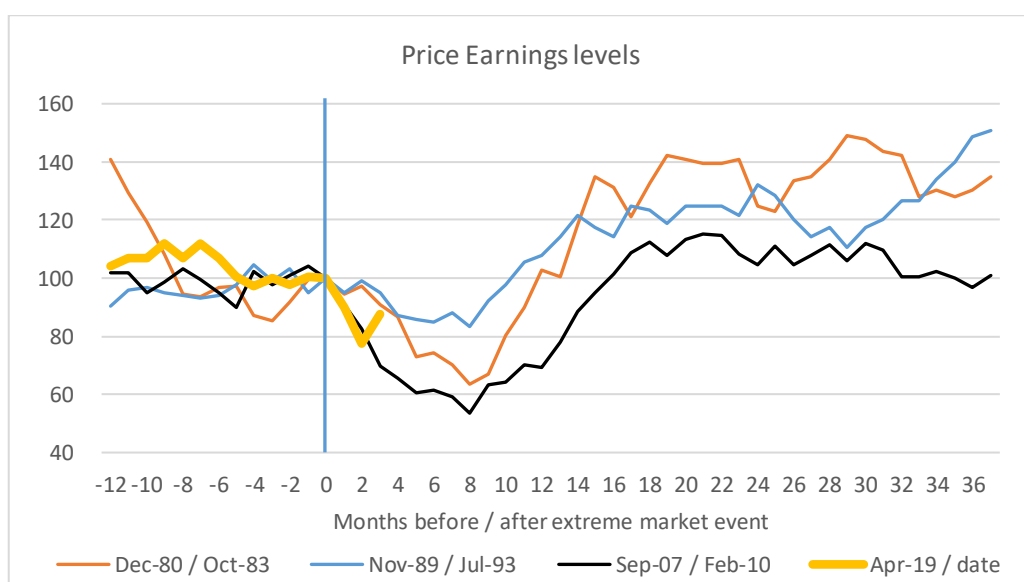
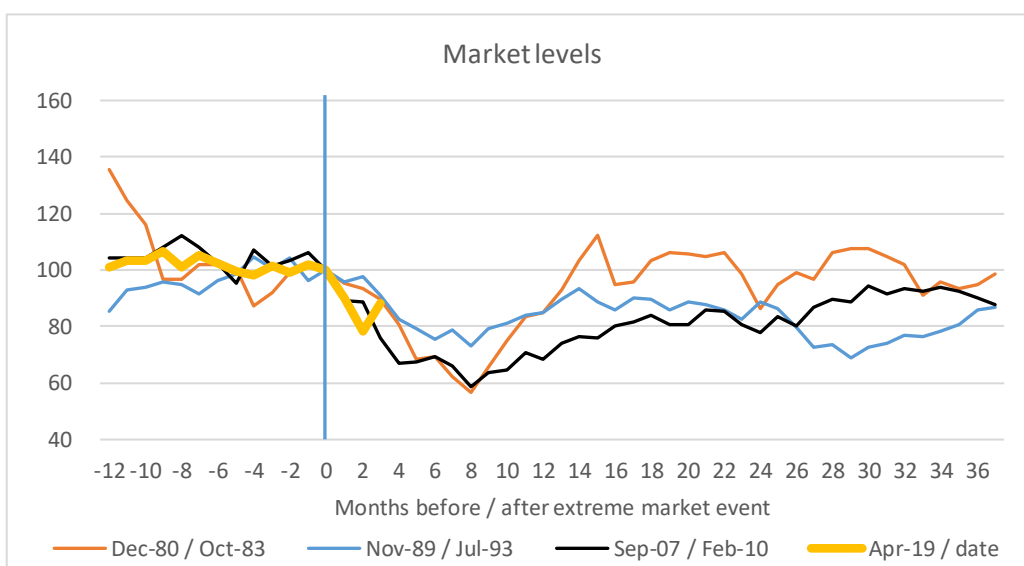
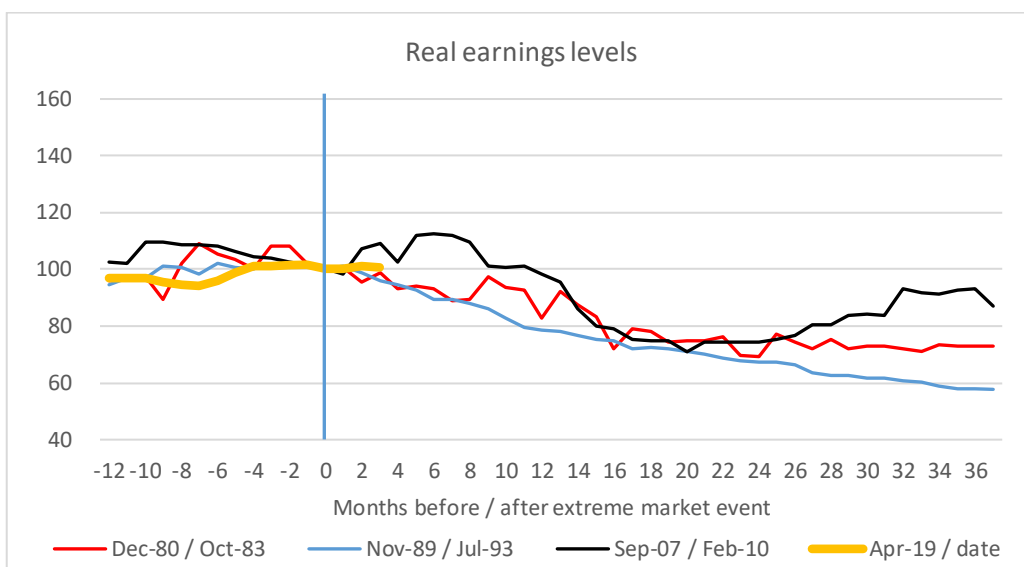
A world of low inflation and interest rates, and expensed (as opposed to capitalised) technology applications and/or developments, can generally support higher market ratings (the discount effect).

In order to assess the current rating, it is perhaps appropriate to look at the peak to trough evidence from other periods. This is shown in the table below.

Month of market peak	Peak PE	Month of market trough	Trough PE	% change in rating	Month of earnings trough	Trough earnings PE	% change in rating from market trough	% change in earnings growth – market trough to earnings trough
Jan-60	11.8	Apr-61	6.6	-44%	Aug-62			
Apr-69	25.6	Oct-71	8.9	-65%	Feb-72	12.2	37%	-4.0%
Mar-74	14.9	Aug-76	4.9	-67%	Aug-77	5.7	16%	-4.6%
Oct-80	9.1	Jun-82	4.1	-55%	Oct-83	8.1	97%	-22.4%
Aug-87	14.7	Feb-88	8.0	-46%	Apr-88	8.4	5%	-1.8%
Jan-90	11	Jan-91	8.8	-20%	Jul-93	16.4	86%	-35.0%
Apr-98	19.4	Aug-98	11.3	-42%	Jan-99	13.3	18%	0.0%
Mar-02	13.8	Apr-03	8.8	-36%	Jul-04	13.6	54%	-11.5%
Oct-07	15.8	Feb-09	8.2	-48%	Feb-10	17.4	112%	-35.3%
Feb-15	18.8	Feb-17	19.8	5%	Nov-16	22.8	15%	-13.3%
Apr-19	18.1	Mar-20	12.6	-30%				

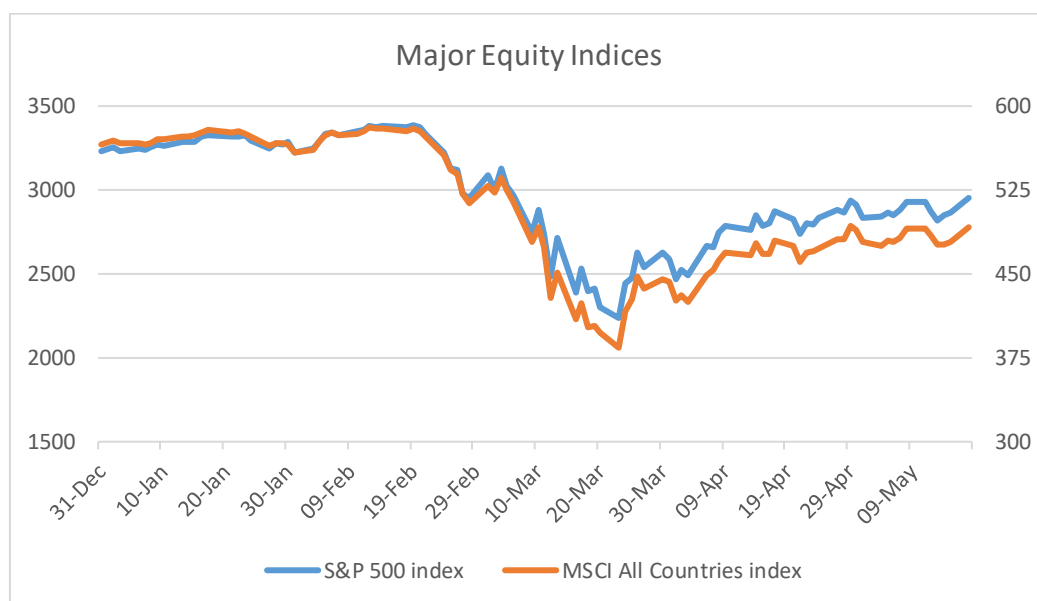
Given our current level of expectations, we will focus on the most severe earnings recessions.

- In terms of severe earnings recessions (more than 30%), there were three events, namely 1980 to 1983, 1989 to 1993, and 2007 to 2010.
- Earnings reduce for at least 24 months peak to trough.
- Market undergoes extreme downside after a peak in earnings.
- PE contracts significantly but recovers strongly to pre-crash levels.
- Charts are all based to 100 at the point of the implied extreme event for comparison.
- We have included the latest period for comparison.



This evidence points overwhelmingly to a far higher probability of more downside, particularly given the scale of the expected earnings recession. So, why did the market “bounce” so strongly? This can almost entirely be ascribed to the level of stimulus injected by governments across the globe.

1. The average stimulus package from the European Union has been approximately 16% of GDP.
2. The United States has authorised some 14% of its GDP, and Japan 21% to date.
3. The South African number was R500bn, which represents approximately 10% of its GDP.
4. These numbers are significantly in excess of that authorised during the Global Financial Crisis by at least a factor of 2.
5. The first major stimulus (US) was announced on 20 March and approved on 25 March 2020.



The future environment for investing will NOT be business as usual in the following ways, for example:

1. Extremely low energy prices support lower inflation.
2. Technology based industries will strengthen their economic moats.
3. The expected global recession will have a severe impact on bankruptcies with associated elevation in credit yield spreads. Industries that are likely to see a significant contraction include retail, tourism, hospitality, entertainment, gaming (excluding online), mining, transportation and motor vehicle manufacturing.
4. Unemployment levels have soared (e.g. in the US these levels are at more than 15% and may hit 25%) and will not revert to pre-crisis levels quickly. South Africa could hit a 50% unemployment rate.
5. Government debt levels will ensure that debt becomes a multi-multi-generational problem.
6. Economic stimulus can ONLY be a short-term intervention and cannot stave off the coming economic contraction indefinitely.
7. The adoption of the digital model supports the new work from home paradigm with a direct impact on emissions and the global climate, and on the office rental market.
8. Reduced consumption during lockdown supports non-materialism amongst millennials (50% of the working population) and will impact future consumption spending patterns.
9. Savings rates are likely to increase as a reserve against future income uncertainty. policies put in place in South Africa reflect a likelihood of the future being anything like the past.

Conclusion

It is extremely rare for a market to recover to the point from which the extreme market event occurred within 36 months, particularly in the face of significant future earnings contractions.

The reduction in the exchange rate implies that SA assets have been discounted by 25% (pre-market movements) in line with downgrades, the repurposing of the fiscus to support state-owned enterprise bail-outs, a reduced tax base and the elevated demands of an economy in lockdown. Reasonable? Yes, but probably excessive, considering a ZAR/USD rate of more than 18.

- We would expect the currency to move back to the ZAR/USD level of between 15 and 16 within the next 3-6 months.
- The only caveat to the above expectation is political; any extreme positioning from the anti-reform brigade could derail the recovery in the rand.

Is this time different? Expectations over the next 36 months:

- The playbook is the same as that used in the Global Financial Crisis – expand Reserve balance sheets, print money and buy assets. But this is not just a financial crisis!
- We do not perceive that this will be a quick “V-shaped” recovery. Lockdowns will have lingering impacts on unemployment, growth and interest rates.
- Global GDP growth will severely contract over next 12 months, then rebase and start expanding. However, we are unlikely to simply resume the path that we were on pre-Covid-19 even with the massive stimulus packages.
- SA growth will similarly be affected. However, there will be a structural adjustment because certain industries, and the associated jobs, will not survive.
- SA real interest rates will remain strongly positive.
- We are unlikely to fully appreciate the full impact of the damage to the economy until well after the recovery has begun. Humans tend to underestimate impacts in the longer term due to linear thinking.

Even if earnings maintain a downward trajectory, market ratings should mitigate, but not completely offset, the effect.

Are we likely to sustain this “bull” market since 22 March? On balance, probably not. However, it may well be a volatile ride.

Local and global events that contributed to or precipitated the negative movements in the markets:

Year	Local event	Global event
1960	<ul style="list-style-type: none"> Sharpeville massacre Withdrawal from Commonwealth 	<ul style="list-style-type: none"> Cuban missile crisis
1969	<ul style="list-style-type: none"> Debt build-up through cold war High inflation 	<ul style="list-style-type: none"> Interest rates series of mini crashes
1974		<ul style="list-style-type: none"> Dramatic rise in oil prices worldwide.
1980	<ul style="list-style-type: none"> Consequences of significant reduction in bullion price after reaching US\$843 (low of US\$ 297 in 1982) with associated impact on SA mining industry 	<ul style="list-style-type: none"> US stagflation
1987	<ul style="list-style-type: none"> Programme trading & illiquidity compounding falls without circuit breakers on NYSE 	
1990		<ul style="list-style-type: none"> Start of the first Gulf War (oil price spike) Start of Japanese deflationary spiral
1998		<ul style="list-style-type: none"> Asian financial/ economic crisis Russian ruble devaluation
2002	<ul style="list-style-type: none"> Mini crashes leading up to extreme volatility 	<ul style="list-style-type: none"> Impact of 9/11 e.g. insurance pay-outs Dot.com bubble burst (associated decline of Nasdaq) Accounting scandals such as Enron and Worldcom
2007		<ul style="list-style-type: none"> Global Financial Crisis Failure of large financial institutions around the world.
2015	<ul style="list-style-type: none"> Nenegate Political uncertainty 	<ul style="list-style-type: none"> Chinese market crash Commodity price rout
2019	<ul style="list-style-type: none"> COVID-19 outbreak 	
2020	<ul style="list-style-type: none"> Global lockdown and associated economic contractions 	

Glacier Research would like to thank Guy Fletcher for his contribution to this week's Funds on Friday.



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Guy Fletcher is the Head of Client Solutions & Research at Sanlam Investments. He joined Sanlam Investments in 2016 as Head of Client Solutions to provide a thought leadership function in the portfolio construction and solutions space for institutional clients. Client Solutions' primary goal is to combine strategic consulting with portfolio management to solve clients' complex investment challenges. This involves analysing external client requirements, identifying preferred outcomes and mapping this against internal capabilities. Client Solutions utilises single and multi-asset concepts across all asset classes, sectors, styles and regions to provide tailored offerings to Sanlam's institutional clients.