

Value or Value Trap? Do Prices Lead Earnings?

Is the recent market a correction a value opportunity or a sign of an impending slowdown? Do prices lead earnings?



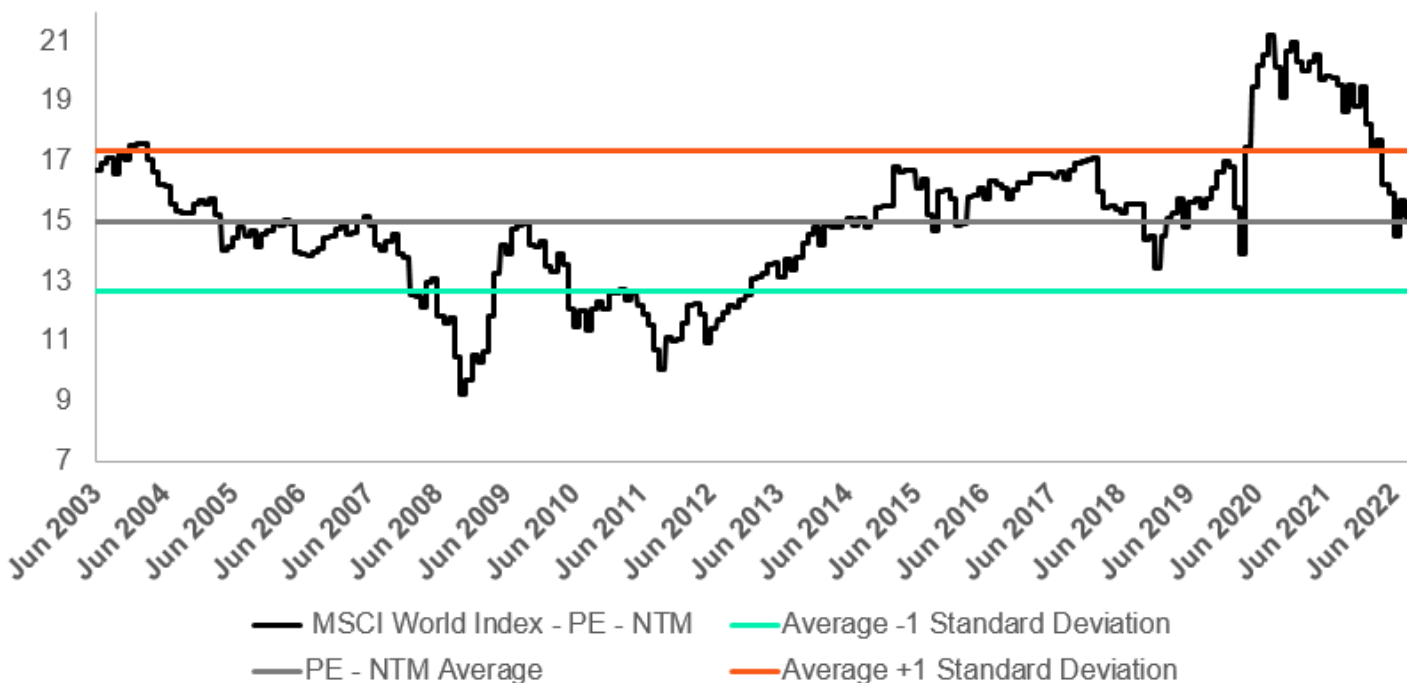
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Value or Value Trap?

After the MSCI World Index correction, year to date¹ does the market now represent good value or is it more a value trap? From a pure valuation perspective the MSCI World Index's price to earnings multiple is close to the 20 year average of ~15x.² Figure 1 provides some historical perspective and includes the average Price to Earnings (PE) (~15x) as well as the average PE plus and minus 1 standard deviation.

As shown the MSCI World Index PE can move to either extreme and remain there for some time. The outlook for earnings, the interest rate environment and the investor risk preferences can all impact the valuation multiples. The two extremes in the last 20 years coincide with the Global Financial Crisis (GFC) of 2008 and the post Covid vaccine 2020 period. We started this correction from an extreme. If you believe the earnings then you can start to make a case for the valuation opportunity. Conversely if you think the market correction is more a sign of a potential earnings slow down then it could well be a value trap. So which tends to lead – prices or earnings?

Figure 1: MSCI World Index PE Ratio Based on Earnings for the Next 12 Months (NTM)



Source: Factset, State Street Global Advisors. Price Earnings Ratio of the next 12 months. 30 June 2003 to 27 October 2022. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Which Leads – Prices or Earnings?

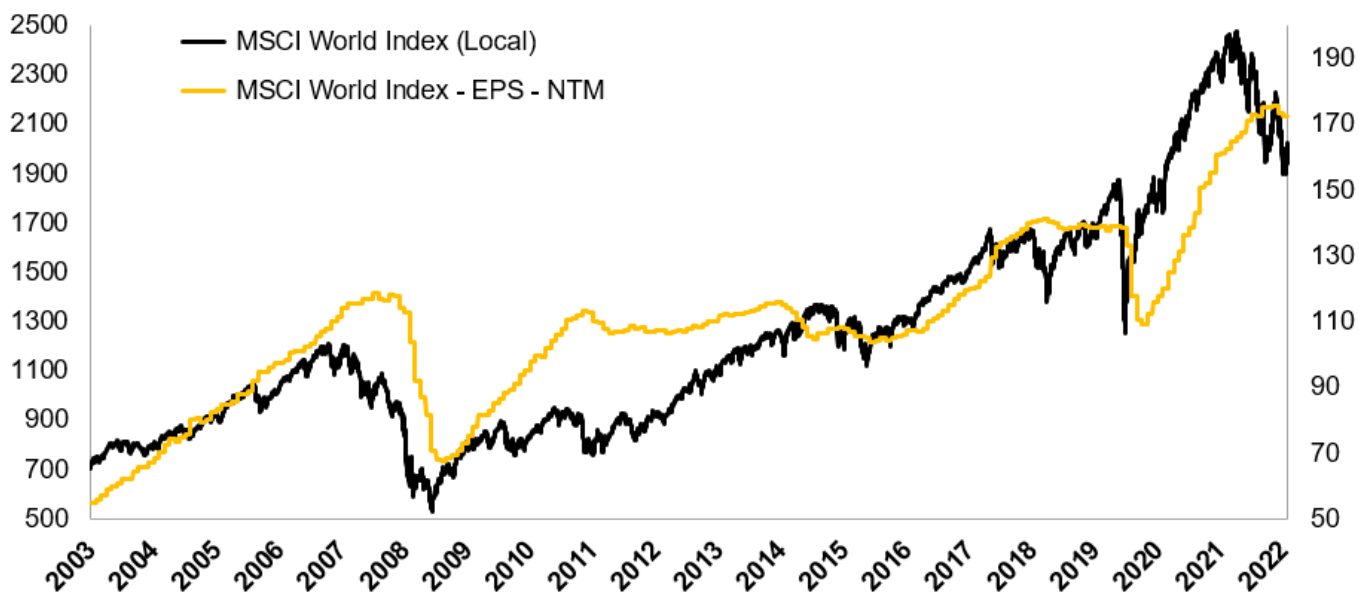
Price and earnings tend to move together most of the time as shown in figure 3 below. All major market up and down moves have been associated with corresponding moves in forward earnings expectations as you would expect based on economic principles. The question as to which comes first is still up for some debate. Figure 2 below looks at the past peaks and troughs for the MSCI World Index and corresponding peaks and troughs in earnings expectations for the MSCI World Index. In the last 20 years we have had 4 major market corrections (4 peaks in the market and 3 bottoms in the market). **As outlined in the Figure 2 prices have led earnings in 5 out of the last 7 peaks and troughs.**³ For market bottoms prices have led earnings in all 3 major bottoms. On average the market put in a low 40 days before earnings bottomed. If prices lead earnings then the current correction may well be the markets assessment of impending economic slowdown.

Figure 2: Major Peaks and Troughs in Earnings and Prices for the MSCI World Index

Category	Description	Date: Market Price Peak or Bottom	Date: Earnings Peak or Bottom	Comments
Market Peak	GCF	26-Oct-2007	04-Apr-2008	Prices Lead earnings by 161 days
Market Bottom	GFC	06-Mar-2009	17-Apr-2009	Prices lead earnings by 42 days
Market Peak	2015 Peak	29-May-2015	28-Oct-2014	Earnings lead price by 213 days
Market Bottom	2016 Bottom	12-Feb-2016	26-Feb-2016	Prices lead earnings by 14 days
Market Peak	Covid Peak	21-Feb-2020	13-Dec-2019	Earnings lead price by 70 days
Market Bottom	Covid Bottom	20-Mar-2020	22-May-2020	Prices lead earnings by 63 days
Market Peak	Inflation & Tightening	31-Dec-2021	03-Jun-2022	Prices lead earnings by 154 days

Source: Factset, State Street Global Advisors as of 27 October 2022. MSCI World Index is calculated in local currency. Earnings are aggregate estimates for the MSCI World Index for the next 12 months.

Figure 3: Earnings and Prices for the MSCI World Index



Source: Factset, State Street Global Advisors as of 27 October 2022. MSCI World Index is calculated in local currency. Earnings are aggregate estimates for the MSCI World Index for the next 12 months. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

The bulk of economic indicators are now pointing towards continued economic contraction and the risk to earnings continues to build. Adding to the valuation concerns are higher long term interest rates which imply lower equity multiples and the more uncertain economic environment which increases investor risk aversion further suggesting lower valuation multiples can be justified in the current environment.

The Bottom Line

Valuation opportunities often come with extra risk and require extra scrutiny to understand the earnings trend. With tighter monetary policy yet to fully play out global earnings risk grows.

Footnotes:

¹ Source: Factset as of 27 October 2022.

² Source: Factset as of 27 October 2022.

³ Source: Factset as of 14 October 2022.

Important Disclosures

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