



The Other E Word

May 2022

It may have been the federal election that captured the spotlight at home over the past several weeks. However for investors, it will be the other E word that will become the key concern going forward. A word that was seemingly forgotten in the blue-sky era of the bull market, namely earnings. It will be the market's focus amid the blazing campaign trail by the bears that we have likely not seen the end of yet.

The notion that we have fallen into a bear market now seems like a given, as is the fact that economic momentum is slowing, inflation is high and that rates are rising. In this unforgiving climate it is yesterday's high-flying heroes that have become today's villains – just try mentioning “profitless tech” at a dinner table. Take ARK, the poster child of the category, as an example. Its precipitous fall from grace closely mirrors the Tech Wreck of the 2000s (Chart 1).

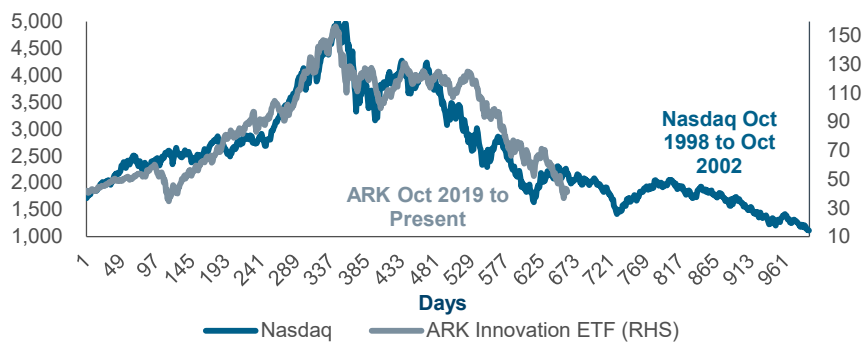
The Australian equity market with its greater exposure to Financials and Resources has to date remained relatively resilient amid the sell-off. Yet if history is a guide, we are likely in the early innings of a local bear market (Chart 2). Also importantly, most of the share price weakness both domestic and offshore has been driven by valuation de-ratings. At this late stage of the cycle, valuation corrections always occur first as expensive premiums revert lower. At earlier stages, earnings seemed to take a back seat to appetizing mixes of sales growth and a good story.

However, the key concern going forward will be the earnings component of the valuation multiple. Earnings expectations have held up well globally (Chart 4), however we believe they are not pricing the full extent of the cyclical risk ahead. Despite a notable de-rating YTD (orange bar in Chart 3), markets



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(Fig. 1) ARK vs the Tech Wreck

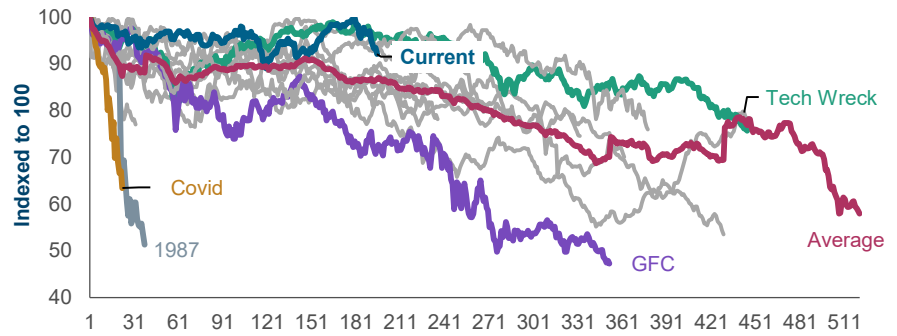


Past performance is not a reliable indicator of future performance.

Source: Factset, as at 17 May 2022.

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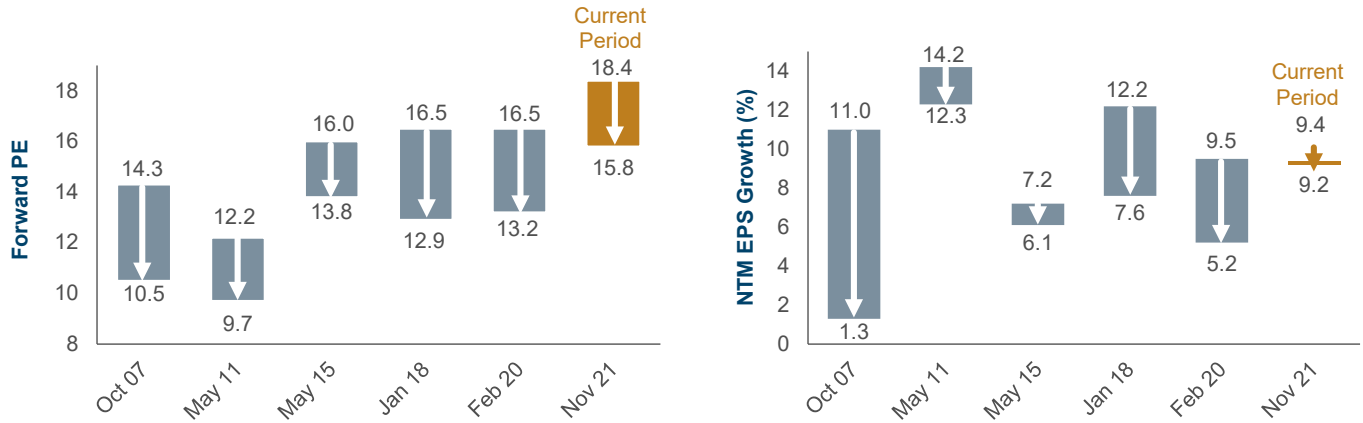
(Fig. 2) MSCI Australia bear market comparisons



Past performance is not a reliable indicator of future performance.

Source: Morgan Stanley, data from 31/12/1971 to 12/05/2022, Bear Markets comprise sell-offs of more than 20% from the previous peak.

(Fig. 3 and 4) MSCI ACWI valuation and earnings changes during prior bear markets



Source: Morgan Stanley, as at 13 May 2022.

remain vulnerable to weaker earnings. Higher costs and weaker demand are not a good cocktail for valuations in the near term.

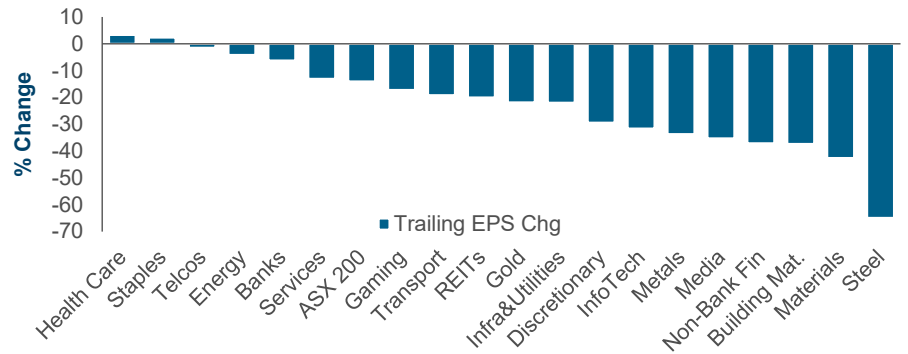
The earnings picture also does not appear to reflect the more aggressive monetary tightening cycle now expected by markets. The RBA's latest move puts the number of major central banks that have hiked in the past 3 months at 28 out of 37, the highest since 1992. Higher inflation, partly induced by monetary policy errors mean conditions will need to be tightened more than initially anticipated.

Things aren't all bad. As we highlighted in last month's note, we believe Australia is relatively better positioned

to weather a storm than offshore and domestic earnings should be more sheltered than peers. The earnings outlook has actually improved this year (largely thanks to Resources). Additionally, the sell-off has presented some long-term opportunities in more attractively valued Growth-At-A-Reasonable-Price (GARP) names. At the same time, we are cognisant that cyclicals carry a greater risk of downgrades (Chart 5) and in turn prefer more defensive exposures in areas such as Health Care and Consumer Staples.

We believe quality names (those higher profitability companies with lower earnings volatility and strong balance sheets) will also likely perform

(Fig. 5) Average peak to trough earnings movements during rate hike cycles



Source: Goldman Sachs, as at 29 April 2022.

well amid rising cost pressures and weaker margins. Meanwhile, unlike the decisive election win, we don't believe there will be a clear winner in the growth vs value battle in this environment. The periods of decade long rotations are likely behind us. As are the days where overoptimistic

stories alone could drive extreme valuation re-ratings – earnings and fundamentals will be the focus in the bear market arena.

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