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Investing for a world of change

Earnings hold the key

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Have global equities performed as expected this year, given everything that's been thrown at them?

It has been an unusual year as there have been a number of things that investors have had to grapple with. While the spike in inflation was expected, the very sharp rise in policy rates, notable increases for both bond yields and the cost of capital, along with a very strong US dollar, were not. These have all proved detrimental to equity markets' performance.

As for where we are now, it is interesting to overlay the sell-off in equity markets with earnings expectations. The latter is what ultimately matters for equity markets, and there has been a degree of disconnect here as corporate earnings momentum has held up much better than leading economic indicators. Share prices are a lot lower this year against this weaker backdrop, but it means that the bulk of the market selloff has been due to a contraction in valuation multiples, and not due to a major earnings downturn. We think that is quite interesting and we are now due a bit of a reset to earnings expectations.

What will be the key drivers of equity markets in 2023? If earnings, are there signs these are going to recover?

Rising expectations for inflation and interest rates defined 2022, but are unlikely to be key drivers going into 2023. Instead, we should expect some disinflation and so corporate earnings could correct meaningfully as demand eases. We also think the intention to keep raising wages seems to be softening.

It is possible investors will start focusing on leading indicators and not just the latest inflation prints. A potential peak in rates would help to ease some of the pressure on equity market valuation multiples, and this may be a key theme in 2023. Returning to earnings, from a regional perspective, a key uncertainty is when China decides to reopen its borders. A caveat would be if there is a post-pandemic recovery in the Chinese economy, resulting in rising global oil demand but no major increases in supply. This would be a pretty interesting setup as commodity price inflation could persist and that would be an unfavourable scenario for equities.

We don't believe we have seen the full impact of the rising cost of living on consumers and, as this occurs with a bit of a lag, the full effects will only be apparent next year. Fortunately, the market is a forward-looking discounting mechanism, meaning that Main Street and Wall Street do not always move in tandem and expectations could certainly reset more favourably, making that a smoother transition into 2023.

What will signal the turning point for the global equity asset class, and where are the opportunities in 2023?

From a bottom-up perspective, we are sceptical about current earnings expectations, which we see as vulnerable to further downgrades. While the contraction in valuation multiples resulting from weaker share prices suggests the market trough might be near, recent corporate results demonstrate there is still significant selling pressure for companies missing earnings expectations. In our view, the absolute key signal for a market bottom in equities will occur when negative earnings surprises are no longer resulting in major price corrections, demonstrating that the bad news has been sufficiently discounted in valuations.

Current uncertainties make for an interesting setup with potential opportunities across a range of sectors. A lot of energy companies benefitted from exceptionally strong free cash-flow generation. They are paying down debt, buying back shares, issuing much higher dividends and returning cash to shareholders. This is a sector we like, notwithstanding the outperformance year-to-date.

There are also great opportunities within industrials for the companies set to benefit from the climate transition and US legislation, such as the Inflation Reduction Act. Elsewhere, key structural drivers in the technology sector are unlikely to fade. There are still a number of stocks with very attractive structural growth opportunities but where valuation multiples have more than halved. Eventually it will be time to revisit a lot of these stocks.

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