MFS INSIGHTS: LOOKING AT EQUITY MARKETS THROUGH AN EARNINGS LENS

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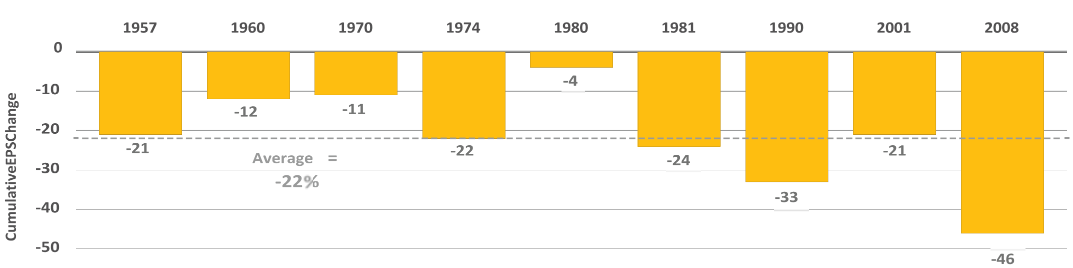
Stock prices in the near term are reacting to the economic news, politics and macro events, but ultimately the pricing of risky assets reflects corporate earnings expectations. The market's historic decline up to this point, in terms of both magnitude and speed, stems from the anticipation of a significant earnings recession given the demand shock and evaporation of capital access brought about by the COVID-19 pandemic. This abrupt shift is far from typical.

While we don't yet know how long this decline will last, we believe its effect, in the short run at least, to be severe. Before the crisis began, earnings quality was below average, valuations were above average and a big part of this long and historic profit cycle was driven by something other than revenue growth. The excessive pursuit of free cash flow in order to appease investors came from balance sheet leverage, manipulation of working capital via supply-chain finance and corporate underinvestment amid materially low operating and capital expenditures. In short, profits were vulnerable.

In the face of a significant demand shock, economic recession and the abrupt contraction in credit availability, many companies now must face harsh realities. Capital markets have raced to discount a precipitous fall in corporate earnings. At the end of 2019, aggregate S&P 500 and MSCI EAFE Index earnings per share were around $152 and $105, respectively. How much will profits fall from those levels?

Looking back at the post World War II era, the chart below illustrates various peak-to-trough percent changes in S&P 500 earnings per share (EPS).

Exhibit 1: S&P 500 EPS Declines (Peak to Trough) During Recessionary Periods



Source: Bloomberg. S&P 500 monthly data from 31 January 1954 to 28 February 2020. EPS % change is calculated from the peak to trough values during each US recession period. In this analysis, the peak in EPS is defined as the largest EPS value during the recession period while the trough is defined as the lowest value in EPS following the peak before EPS started to rise again. EPS is based on last-twelve-months and is in USD.

Every cycle is unique and features different areas of overinvestment, and euphoria but each follows the same path in at least one respect: Late in the cycle investors underestimate risk and overestimate liquidity. The problem investors face now is a lack of visibility into how severe the fall in earnings could be.

The average earnings fall, as shown above, is 22%. While not representative of the world, the S&P 500 Index offers a reasonable proxy and allows us to make our general point, which is that assuming normal earnings multiples, market levels today have discounted an earnings recession across global equity markets. However, this economic and financial market cycle hasn't been average. As we've been warning for some time, corporate fundamentals have been weaker than they have appeared.

In our view, COVID-19 isn't an ordinary virus, and its impact on the economy will be anything but average. The number of companies that have already drawn down revolving credit lines, cut dividend payments and ceased share buyback plans are too long to list. So coming out of the crisis, we believe judicious security selection will determine the difference between success and failure for many portfolios, bringing opportunity for the prepared and those with skill and patience.