MFS INSIGHTS: LOOKING AT EQUITY MARKETS THROUGH AN EARNINGS LENS — PART II

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In brief:

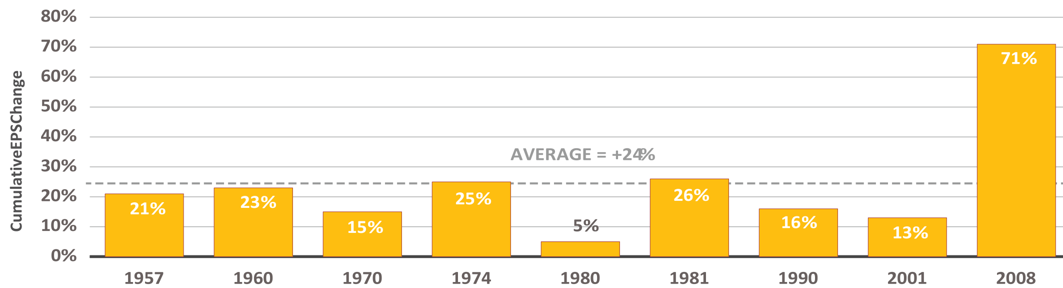
- We believe the coming recovery in earnings will be less robust than normal because the corporate excesses of the just-ended cycle far exceeded those of the past. This will impair any recovery.
- Balance sheets and working capital were vulnerable before the crisis. The shutdown of normal economic activity and the precipitous decline in revenues has not only exposed the inherent fragility of many companies but made things materially more perilous.
- Businesses that navigate their way through this crisis and emerge stronger than before should display high scarcity value when compared with the broad market.

In our view, when thinking about today's approximate fair value levels for the equity market, investors face two challenges. The first is assessing the impact of the current global recession on earnings (as we sought to frame in Looking at Equity Markets Through an Earnings Lens). The second, and the focus of this piece, is on the pace of the recovery. Ultimately, this is what forward-looking investors will put a multiple on.

We fear investors are anchoring to an overly optimistic earnings recovery path, likely infected by a bit of recency bias from the post global financial crisis V-shaped recovery. So we feel compelled to share a historical look back and to offer our perspective.

In the prior piece, we tracked the peak-to-trough decline of earnings per share (EPS) of the S&P 500 index for each post-World War II recession, calculating an average 22% EPS decline. After earnings troughed, what was the rate of EPS growth over the subsequent 12-month period? Exhibit 1 graphs each of those periods and calculates an average of 24%.

Exhibit 1: 12-month rebound from the trough in S&P 500 EPS following recessionary periods



Source: Bloomberg, S&P 500. Monthly data from 31 January 1954 to 28 February 2020. EPS % change is calculated from the trough to 12 months forward following each US recessionary period. In this analysis, the peak in EPS is defined as the largest EPS value during the recession period while 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. Past performance is no guarantee of future results.

Is this a fair guidepost or framework for investors? In our view, no.

We believe the coming recovery in earnings may be less robust than normal because the corporate excesses of the just-ended cycle far exceeded those of the past. This could impair any recovery. Even if we strip out the statistically anomalous period that followed the earnings through from the global financial crisis, we fear the recovery may still underwhelm. Here's why:

As we've written and spoken about — to anyone who would listen — balance sheets and working capital were vulnerable before the crisis. The shutdown of normal economic activity and the precipitous decline in revenues has not only exposed the inherent fragility of many companies but has made things materially more perilous.

While none of us know the path the virus will take or the length of the recession it causes, one thing is clear. For those most at risk, survival becomes the focus. Calvin Coolidge once said "We cannot do everything at once, but we can do something at once."

That something, thank you President Coolidge, is to raise cash. Many companies will need to raise cash, not capital to ensure survival. We detail some of the means companies will use to close critical funding gaps and their ramifications.

- **Reduce or eliminate expenses, particularly labour**. While the optimal solution is to furlough employees, providing management with a call option to bring labour back online quickly for the recovery, this option may prove elusive and inefficient for many, especially small to medium enterprises. The more labour that's lost, the more "know-how" companies lose. The more persistent the pandemic, the greater the opportunity cost because re-acquiring skilled labour takes time and resources.
- **Reduce or eliminate Research and development.** In an age of digitalization and a lower value assigned to physical capital ("things we can count"), a growing portion of companies' equity consists of intellectual property. Any reduction in research and development may not only restrain growth in an economic rebound but more important, could prove disastrous from a long-term competitive standpoint.
- **Force majeure or delayed payments**. We have already begun to hear of companies declaring force majeure, unforeseeable circumstances that prevent an agent from fulfilling a contract, and we anticipate more. We anticipate that those who don't have that legal option will delay payments or default on their obligations

altogether. In any of these scenarios, companies run the risk of damaging corporate relationships and critical supply chains. The inability to source inputs for production or services could impede growth in a recovery.

- **Asset sales and/or leaseback of assets**. While this option raises much needed cash, it reduces operating leverage in a rebound.
- **Capital raises**. As investors who invest in distressed bonds take control of companies, equity capital will need to be raised in order to repay bondholders. Dividend payments already will have ceased. Stock repurchases, a major source of earnings-per-share growth during the just-ended cycle, will fall to zero. In addition, the raising of equity capital will dilute earnings-per-share growth materially in the recovery.
- **Acceptance of government aid comes with conditions**. Companies that borrow from governments will be unable to make capital distributions for a period of time. For example, under the recently signed CARES Act in the United States, companies will be prohibited from returning capital until a year after repaying their loans.
- **Bankruptcies**. We anticipate a significant rise in bankruptcies, particularly amongst small- and medium-sized companies. While this may be factored in by the market already, what will be the second and third order effects on the global economy? What about the companies these firms source parts or services from and the companies they in turn sell to?

While each company has its own idiosyncrasies and will hopefully chose the path that leads to an optimal outcome, many of these paths come at the expense of future growth potential. We can debate whether these profit-minimizing actions come fully to fruition. But, does it matter? It does if you own the market, but we do not. Nor do our clients.

In our view, investing is not a science. But we believe if there is one law of finance, it is that company fundamentals drive free cash flow, and free cash flow drives asset prices. This crisis will kill some companies and cause others to become laggards. Yet some companies will navigate their way through and emerge stronger. Unlike the past 11 years, the marketplace will soon have clear free cash flow visibility into each of these groupings, and asset prices will adjust accordingly. As active managers, we're excited about what's to come. Almost as excited about the idea of one day leaving the house for work!

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