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Recession Fears and Earnings

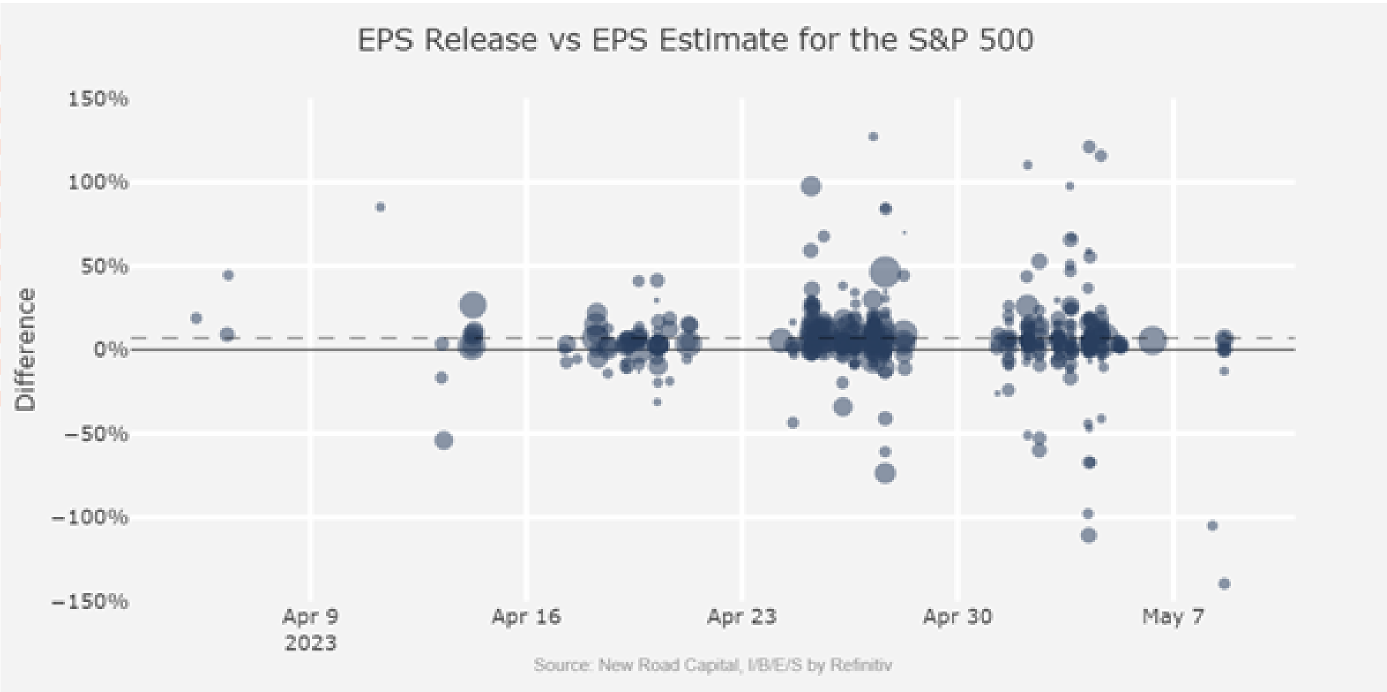
by Garrett Nel

Fear of a global recession has been a dominating topic since the start of 2023 as central banks around the world continue to raise rates in their fights against inflation. The possibility of recession hangs in the balance and largely depends on the interest rate trajectory, which looks to be abating, but the feared consequences are heavily based on historic experience. For example, since the year 2000, the US has experienced three recessions, of which all were preceded by periods of rising rates.

Consensus estimates currently point toward the US experiencing a recession toward the end of 2023 but predict that it would be a mild recession. This is in contrast with the deep recessions experienced in 2008, during which US GDP growth reached a minimum of -3.3% year-on-year, or the aftermath of the pandemic lockdowns in 2020, which shrunk the US economy by 7.7%. Given current recession expectations, if the US does experience an economic downturn, it would likely be similar to the recession experienced during 2001, which was shorter and shallower than those of 2008 and 2020.

Although markets did drop substantially during the 2001 recession, the valuation of the stock market was in bubble territory. Before the 2001 Dotcom bubble burst, US equities were heavily over valued; the price to earnings ratio (PE) reached a maximum of more than 45 at the top of the market.

Following the latest earnings season in the US, the current S&P500 PE ratio is 18.5, much more reasonably valued. Additionally, earnings for the last financial quarter have exceeded analyst expectations by a comfortable margin. The figure below shows the difference between actual reported earnings and analyst expected earnings for each of the S&P 500 companies for the first quarter of 2023.



On average, earnings were 7% better than forecast, with 77% of companies beating analyst forecasts—including the large-cap FAANG members. The implication is that, at least for the first quarter of 2023, US businesses have not been affected by the predicted economic slow-down to the extent that was anticipated. Although not impossible for global markets to fall into another bear market, it is important to consider the underlying data before making conclusions. With the current backdrop of a more reasonably valued equity market, coupled with better than estimated earnings performance so far, and considering that the S&P500 is already over 13% below its all-time high—in preparation for one of the most anticipated recessions in history—things may turn out to be different than expected.

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