

UBS Investment Research
Macro Keys

Where the consensus is wrong

“Probable impossibilities are to be preferred to improbable possibilities.”
- Aristotle

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Since the start of Q1 earnings season we’ve fielded a number of questions about the prospects for earnings growth and potential surprises to consensus forecasts. For the current quarter we see little in the way of aggregate surprises – up or down. Over the balance of the year however, the risks are clearly to the downside.

Global Macro Team

We expect global earnings growth of just low to mid-single-digits for 2012. This compares to the current bottom-up consensus estimate of nearly 12% – more than twice the growth we are expecting.

Christopher Ferrarone

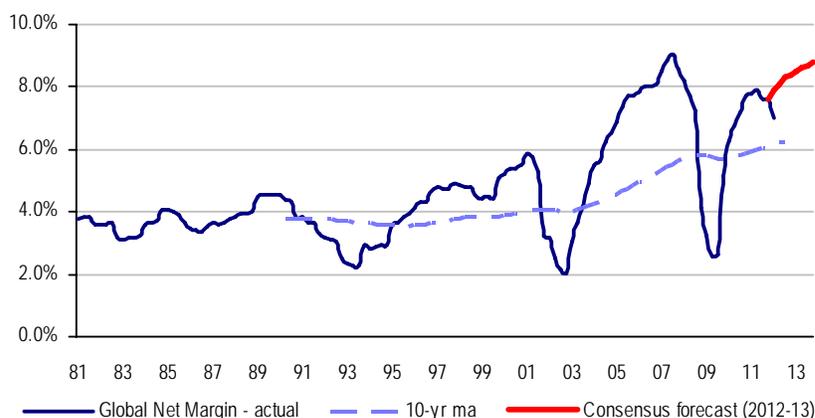
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So where is the gap? Regular readers will know our position: the 12% consensus earnings estimate is based on a revenue growth forecast of just 5%, which implies a significant expansion in profit margins (the same trend is in place for 2013 consensus estimates, incidentally). Chart 1 shows the cyclical trend in global margins over the last 30 years as well as what the consensus forecast implies through 2013. The problem for the consensus is that profit margins have already started to roll over under fairly typical (and strong) cyclical forces that make re-expansion highly unlikely.

So what does this mean for equity markets? As we explain in more detail below, there are both positive and negative implications. Certainly a downturn in the margin cycle means lower earnings growth and pressure on ROE. But it is not all bad: if the driving force behind this margin cycle continues to be increased hiring and wage growth, markets can get support from a more sustainable economic backdrop and improved confidence.

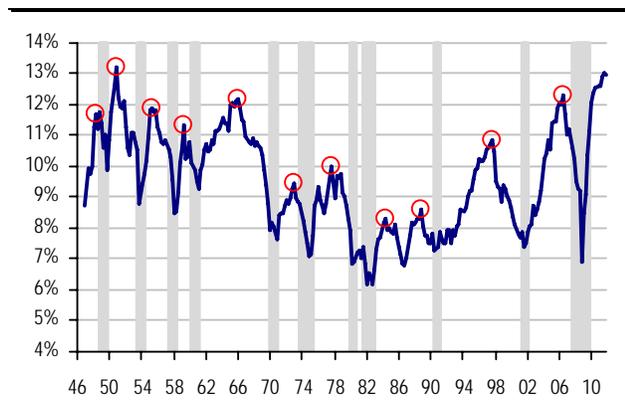
Chart 1: Global Net Profit Margin


Source: Datastream, IBES, UBS Global Equity Strategy

First the bad news . . .

Peaks in the profit margin cycle are typically followed by several years of lacklustre earning growth. A simple analysis of the US margin cycle and S&P 500 earnings growth shows that after a peak in margins (Chart 2) earnings growth over the subsequent 3 year period averages just 3% per annum (Table 1), versus the long-term average of close to 6%. And in 5 of the 11 cases examined, earnings actually fell in the 3 years following the peak.

Chart 2: US profit share of GDP



Source: Haver, UBS Global Equity Strategy

Table 1: Earnings growth CAGR post cyclical margin peaks

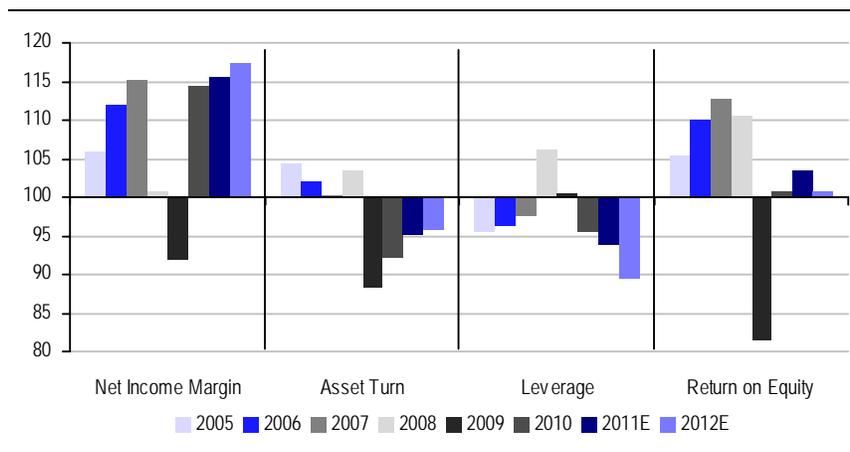
Peaks	1 year	3 year	5 year
2Q48	29%	16%	7%
4Q50	-11%	-3%	6%
2Q55	13%	-1%	1%
2Q59	0%	-1%	4%
1Q66	2%	3%	-1%
1Q73	28%	6%	13%
3Q77	9%	14%	6%
2Q84	3%	5%	13%
4Q88	2%	-6%	0%
3Q97	1%	10%	0%
3Q06	8%	-13%	1%
Average	8%	3%	5%
Median	3%	3%	4%

Source: UBS Global Equity Strategy

Falling margins are also a headwind for returns on equity. As Chart 3 shows, almost all of the improvement in ROE over the last cycle was driven by margin expansion. With this tailwind now turning to a headwind, one must look to asset turns and/or leverage for support.

Further, consensus estimates will have to come down at some point, likely creating some turbulence for equity markets, although this does not seem likely until later in the year.

Chart 3: World DuPont ROE breakdown (2004 rebased to 100)



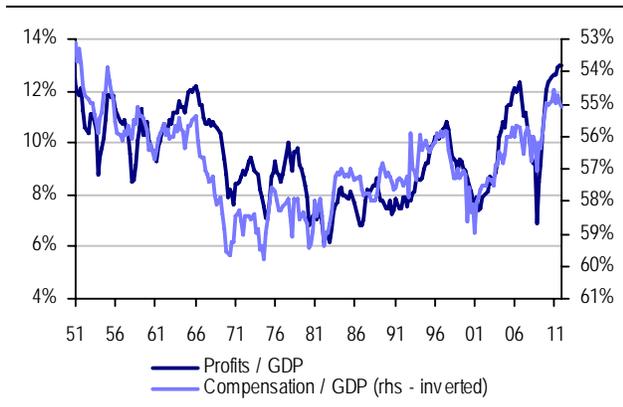
Source: UBS Global Equity Strategy

And now the good news . . .

Labour market trends, particularly compensation costs, are critical drivers of profitability. As Chart 4 shows, there are strong linkages between compensation and profits. It's no coincidence that labour market formation in the US over the last few quarters has been followed by a pick up in unit labour costs (Chart 5) and a peaking in profit margins.

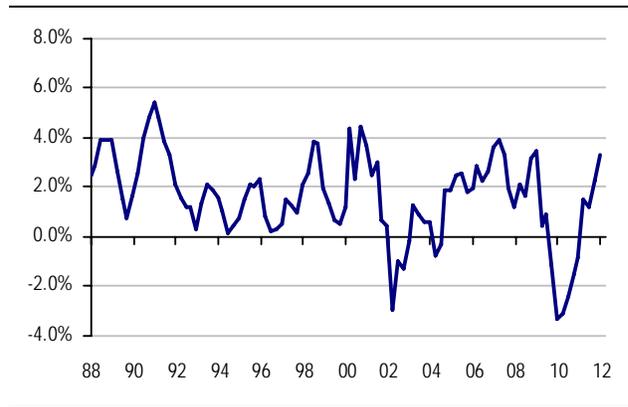
It's also no coincidence that equity markets have moved higher over the last several months. As we've noted several times recently, the improvement in the global growth backdrop has been a critical support for equities. Improving labour markets – and income growth – while not great for corporate profitability, do support a continued recovery in consumer spending and stronger business confidence. These are critical features for a more sustainable economic backdrop that can translate to lower risk premia and higher valuation multiples and support equity returns in the face of slower growth.

Chart 4: US Corp Profits and Compensation as % of GDP



Source: Haver, UBS Global Equity Strategy

Chart 5: US Unit Labour Costs, non-financials (SA, y-o-y chg)



Source: Haver, UBS Global Equity Strategy

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