DOES FORECAST UNCERTAINTY MATTER? IT DEPENDS

The publication by the ECB of different economic scenarios illustrates the extent of uncertainty which at present surrounds the forecasts for key macroeconomic variables. As a consequence, companies may hold off investing, preferring to wait for better visibility. While understandable at the micro level, such a wait-and-see attitude could act as a drag on growth and reinforce the view of companies that their caution was warranted. The large increase in the dispersion of earnings forecasts points to huge uncertainty at the individual company level. However this has not stopped the US equity market from rallying. Although several factors help to explain these different reactions to uncertainty, such dissension cannot last forever. At some point company cautiousness or investor bullishness will have to give in.

The Covid-19 pandemic has not only caused a huge drop in demand and activity, it has also caused a jump in forecast uncertainty. This phenomenon is typical for recessions and is due to the difficulty of anticipating the strength and speed of recovery.

Psychological factors like confidence and animal spirits play an important role but they are hard to anticipate. During the previous recession, the consensus forecast for real US GDP growth in 2009 was -1.3% with a range between -2.5% and 0.3%[1]. The current Bloomberg consensus for 2020 is -5.9% with a range between -10.5% and -2.5%. For next year, the equivalent numbers are 4.1%, 0.5% and 11.4%. The forecast ranges today are five times bigger than at the end of 2008. This illustrates the uncertainty concerning the severity of the recession and the potential for a rebound. These swings make forecasting a particularly difficult exercise.

Macro uncertainty tends to go hand in hand with micro uncertainty. To visualise the latter, the chart shows the dispersion of earnings per share forecasts for the next 12 months. This uncertainty measure has seen a big jump, twice as high as in 2008. Such an abnormally big movement should not come as a surprise given the nature and extent of the current crisis. What is perhaps more striking is the development of the US equity market. Whereas in the past, a sudden increase of the uncertainty about the earnings outlook used to be accompanied by a decline in share prices, in the past three months we have seen a rather short-lived decline in equities followed by a significant rally, although the uncertainty about the earnings outlook remains at a very high level. Confronted with reduced earnings visibility, market participants have probably shortened their investment horizon and stopped worrying how profits will evolve. Monetary and fiscal policy support, as well as the gap between dividend yields and bond yields, then provide the motivation for buying equities in the short run, all the more so considering that low transaction costs imply that the position can easily be closed should things turn out differently than expected.

The reaction of company boards is quite different. A blurred earnings outlook will create a reluctance to invest and increase capacity, pending better visibility about the future. Contrary to financial investments, capital formation is difficult to reverse once a project has been launched, so faced with high transaction costs companies will tend to adopt a wait-and-see attitude. While understandable at the micro level, such caution if generally adopted comes with a macro cost in terms of slower growth. This in turn can strengthen the conviction of corporate executives who have argued it is better to feel safe than sorry. However, a big difference between financial markets and companies in terms of attitude to the same sources of uncertainty cannot last forever. Either growth picks up, creating an impression of improved visibility and corporate animal spirits make a comeback or growth remains subdued and markets start to worry about the earnings outlook. Unless the Fed comes to the rescue again.

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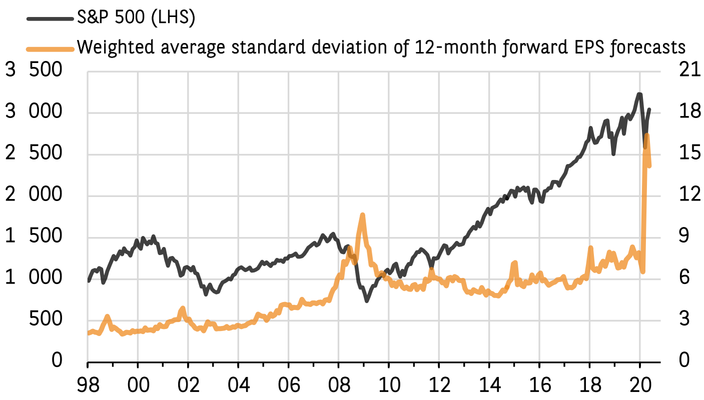
US : CORPORATE EARNINGS UNCERTAINTY AND EQUITY MARKET



SOURCE: STANDARD AND POOR'S, IBES, DATASTREAM, BNP PARIBAS

1. Source : Consensus Forecasts, December 2008. Real GDP growth turned out to be -2.5% in 2009.

> A big difference between financial markets and companies in terms of attitude to the same sources of uncertainty cannot last forever. Either growth picks up and corporate animal spirits make a comeback or growth remains subdued and investors throw in the towel unless the Fed comes to the rescue again.