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STRATEGAS

# insight

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## The “Earnings Recession” that Wasn’t

Although nothing new, questions do persist about the long cycle’s durability. A cursory look at recent headlines from the financial press (e.g.,“Global Growth Enters Synchronized Slowdown,”*Financial Times*) might leave one believing that the worst is upon (and even ahead), as opposed to behind us. We fully acknowledge that the pace of domestic growth has moderated, and given headline weakness, the potential is real for the market to advance to fatigue. Our expectations for domestic returns in the next one to three months are tempered by the recently underway 1Q2019 earnings reporting season, delays in reaching a trade deal with China, and macro miscellany (Brexit; EU auto tariffs; Japan VAT tax increase; the US’s debt ceiling debate, etc.). But overt pessimism seems unsubstantiated to us. Recent data suggest that the US economy, albeit growing more slowly than perhaps desired, remains on firm footing and has even started to reaccelerate. The ISM Manufacturing Index ticked up to 55.3 in March, and although the nonmanufacturing index dipped to 56.1 for the month, its reading places it firmly in expansion territory. Construction spending rose 1.00% month over month in February (its most recent reading). Industrial commodity prices (copper, iron ore, steel) remain strong, global auto orders are improving, and the US money supply (M2) has started to bottom on a year-over-year basis. Cyclical stocks continue to exhibit leadership: Consumer Discretionary is outperforming Consumer Staples, high beta is outpacing low beta, Industrials have outperformed the broader market year to date, and the semiconductor industry has soared to all-time highs). Weekly jobless claims dropped to 202,000 the week of April 4—the lowest number since 1969! These data underpin the erosion in heightened levels of uncertainty extant at the start of the year. Thus, we maintain our view (once decidedly out of consensus but increasingly gathering attention, if not acceptance) that policymakers will be able to engineer an economic “soft landing.”

The equity market’s upward move off its Christmas Eve low now ranks fourth by order of magnitude (23.00%) among all bear-market recovery rallies since 1950. Only November 2008-January 2009 (27.40%), September 2001-January 2002 (24.60%), and July-August 2002 (24.40%) were stronger), and at 70-plus trading days, this rally is the longest by duration. The strength of this move does raise concerns that the market may be overbought in the near term, irrespective of its fundamental underpinnings. In fact, the S&P 500 Index’s rolling 65-day percentage change puts it in the 99th percentile of all historical observations, which have tended to correlate with mixed returns in the near term but, following a period of consolidation, have preceded above-average returns six and 12 months out. Against this backdrop, and acknowledging the need for fundamental follow through, **the most intriguing signpost of nascent growth is the recent improvement in profit guidance.**

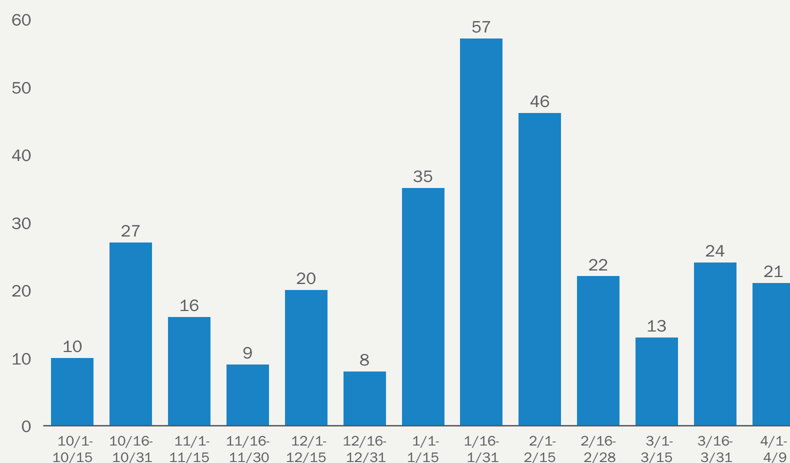
## S&P 500 Price & NTM EPS

*Source: Strategas*

Too often the Street's effort to estimate corporate profits comes off as a parlor game. But, understanding where aggregate profits are heading a year out provides both an important information coefficient for the risks and opportunities in the equity market generally and a benchmark for separating superior operators from marginal operators, particularly as the cycle transitions to its later stages (i.e., the slowing expansion). To that end, corporate operators certainly had sufficient "global macro" cover—weakening global growth profile, fiscal and monetary policy uncertainty, the protracted US government shutdown, political and geopolitical operating headwinds, and a serious hangover from the market's 4Q2018 sell-off—to reduce profit guidance dramatically for 2019. With a nagging desire to reduce the lofty estimates it extrapolated from 2018's growth rates enhanced by the tax cuts, particularly for 1Q2019, the Street was quick to take its cue, resulting in a decidedly negative revision sequence at the start of the year. Consider that for all the discussion of an "earnings recession," Street estimates for 2Q2019 are in line with 4Q2018, while 2H2019 estimates remain above this cycle's 3Q2018 high watermark. As we noted above, 1Q2019's reporting season is underway, and we soon will have a fuller picture of the impact the drawdown in corporate activity had on the real economy at the beginning of the year. That said, despite the Street's sharp downward revision, we anticipate 1Q2019 corporate profits to surprise above current estimates, given that pessimism was largely rooted in transient headwinds. In the same vein that the Atlanta Fed's coincident GDPNow growth tracker has been notching higher, we already can see, even before the bulk of companies report 1Q2019 results, that the pace of downward estimate revisions has moderated materially. So much so that the constant maturity NTM estimate of aggregate S&P 500 Index EPS bottomed in mid-February 2019 and has been edging higher ever since. Partner this with evidence that the economy—although slowing—is still growing, and the underpinnings of stronger-than-expected corporate results may be in the offing for the second and third quarters of the year.

Apart from the "recession is imminent" faction, **our forecast diverges most acutely from the consensus in the emerging view**

## Bloomberg Article Count: "Earnings Recession"




*Source: Strategas*



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**that the Federal Reserve (the Fed) is positioning to cut rates.** The bond market is pricing in cuts over the next nine to 18 months (federal funds futures show 66% odds of a cut between now and January 2020.) However, in our view, the Fed pause is working: Activity in interest-rate-sensitive corners has picked up: US vehicle sales rose +5.30% month over month to a 17.5 million SAAR in March, mortgage applications for purchase rose 3.40% week over week last week, and the 3-month/10-year U.S. Treasury yield curve, after a slight inversion, has moved back into positive territory. We see the yield curve slowly continuing to ease out of near-inversion territory over the next three months, with the yield on the 10-year U.S. Treasury ending the year near, but now below, 3.00%. Thus, our math suggests that the hurdle for the Fed to cut rates is higher than the market is discounting. As long as wages continue to grow above 3.0% year over year (and they are currently up 3.20%), we believe the Fed will find little justification to cut rates.

## Advisor Takeaway:

The pessimistic headlines indicating an end to the long cycle diverge from the strength of the underlying economic data, including manufacturing, commodity prices, employment, and the stock market's leadership in high beta and cyclical stocks, which suggest a slowing, but still growing economy. Should a recession occur, policymakers have the tools to engineer a "soft landing." Acknowledging the market's fourth-highest move off its bear-market low implies that it could be over bought, history shows that mixed near-term returns after a period of consolidation tend to give way to above-average performance six to 12 months out. Also, improved profit guidance is in sharp contrast with Street estimates for an earnings recession at the beginning of the year: 2Q2019 is on track with 4Q2018 and 2H2019 is above 3Q2018's high watermark, and the pace of downward revisions is moderating. Even more important, despite the consensus that the Fed will cut rates, interest-rate-sensitive activity in the economy is rising, and the brief inverted yield curve has turned positive. If wages continue to grow above 3.00% (they are now at 3.20%), the Fed may have scant justification to raise rates.

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Strategas is a global institutional brokerage and advisory firm. The Firm provides macro research, capital market and corporate advisory services, and investment management solutions to institutional investors and corporate executives in more than twenty countries around the world.

Founded in 2006 by Jason DeSena Trennert, Nicholas Bohnsack, and Don Rissmiller, the Firm was acquired by Baird Financial Group in 2018. Strategas operates independently as a wholly-owned subsidiary of Baird and offers institutional securities services through Strategas Securities, LLC, a broker-dealer, and investment management solutions, including this commentary, through Strategas Asset Management, LLC, a registered investment advisor.

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**Index Overview & Key Definitions**

**Fed, The Fed or FED** refers to the Federal Reserve System, the central bank of the United States. **Fed Funds Rate**, the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **Gross Domestic Product (GDP)** rate is a measurement of the output of goods and services produced by labor and property located in the United States. **Real Gross Domestic Product (GDP)** is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year. **Nominal Gross Domestic Product** is gross domestic product (GDP) evaluated at current market prices. The **S&P 500 Index** is an unmanaged index comprised of 500 widely held securities considered to be representative of the stock market in general. The **Russell 2000 Index** is an unmanaged index considered representative of small-cap stocks. The **PCE (Personal Consumption Expenditure) Index** of Prices is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures; essentially a measure of goods and services targeted towards individuals and consumed by individuals. The **Producer Price Index (PPI)** program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services. **FAANG** is an acronym for the five of the market's most popular tech stocks, namely Facebook, Apple, Amazon, Netflix and Alphabet's Google. The **North American Free Trade Agreement (NAFTA)** is an agreement signed by Canada, Mexico, and the United States, creating a trilateral trade bloc in North America. The **Seasonally Adjusted Annual Rate (SAAR)** is a rate that is adjusted to take into account typical seasonal fluctuations in data and is expressed as an annual total. SAARs are used for data affected by seasonality, when it could be misleading to directly compare different times of the year. The **Atlanta Fed GDPNow** forecasting model provides a "nowcast" of the official estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the U.S. Bureau of Economic Analysis. GDPNow is not an official forecast of the Atlanta Fed. Rather, it is best viewed as a running estimate of real GDP growth based on available data for the current measured quarter.

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