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# An Earnings Recession

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By Carl Scholtz

2015 is shaping up to be a very unusual year for the investment community. Despite a solid U.S. economy as well as an improving Europe, the S&P 500 is likely to have negative or flattish earnings growth for the year. In an environment where the Federal Reserve is on the precipice of a tightening cycle, it is hard to envision a robust stock market for 2015. However, we believe the market will likely float higher for a modest gain as 2016 comes into view. More important, we believe the reasons for weak S&P earnings will drive a wide dispersion in stock performance – enabling active investors the potential to generate excess returns.

Over the past six months, the projected S&P earnings growth for 2015 has fallen from over 10% to a paltry 2% with the biggest driver undoubtedly being foreign exchange rates. Companies in the S&P 500 derive roughly 46% of their sales from overseas markets. On a purely translational basis, an increasing U.S. dollar shrinks the value of these profits. Additionally, companies that export goods are likely to see headwinds as their effective prices increase from a foreign buyers' perspective, hindering demand. Besides foreign exchange rates, oil's fall is ironically another big driver of the falling S&P earnings forecast. With oil down over 50% from its highs last summer, it is not surprising that S&P 500 energy companies' earnings are expected to fall 60%. Given its weighting, this is a five to six point headwind to S&P earnings growth. The surprising corollary though has been that we haven't seen the corresponding tailwind to the rest of the economy. A notable economist believes the tailwind to the economy could be ~$200 billion while the headwind from the oil patch could be ~$100 billion, a net gain of $100 billion.

We think there are a few things to remember though. First, the oil companies are in crisis and will take the $100 billion headwind almost immediately. Second, the primary tailwind from lower oil flows to consumers, but this doesn't necessarily assert itself immediately. It takes time for the consumer to build up the confidence and extra cash flow before it spills back into the economy. Lastly, we think on a qualitative basis we must remember that a majority of the $100 billion headwind to the energy companies will flow through to publically traded energy companies, but much of the $200 billion tailwind isn't benefitting just publically traded companies. Mom and Pop retail stores that see a boost in customers from lower oil do not help out S&P 500 earnings.

Ironically, there has even been some modest debate among pundits about whether lower oil prices are even good for the U.S. economy. While I recognize that the U.S. oil production growth has stifled the benefit we may have felt in the past, it seems to us to be unequivocally positive. There is a reason why every macro-economics 101 course being taught uses an "oil shock" of higher prices as a means to derailing the economy. A big fall in oil would only have the corresponding benefit. As such, we remain bullish on U.S. economic growth for 2015. While the first quarter began a little choppy, we think a good chunk of these issues were weather related as well as affected by the California port strike. Unemployment continues to edge down and there is some indication that wages are starting to tick up as well. Part of the problem the last few years is that U.S. consumers have been so focused on debt de-leveraging, they haven't put the few incremental dollars they earn back in the economy. Given U.S. household debt is down, we think wage growth could have a pronounced impact on the demand side of the economic equation. We also believe that housing could be a nice tailwind over the next few months given its multiplier effect. While housing start data has been mixed recently, home sales have been very strong and we think the builders will begin to ramp up their supply.

So, the big U.S. economic question will be when the Fed raises rates and how the economy will respond. With unemployment continuing to fall, it seems to be just a matter of getting inflation expectations closer to their target of 2%. The year-over-year core CPI is around 1.8% while the Fed's preferred measure of inflation, core PCE, registered 1.4% in February. It seems to be inching up, but will take more time. Whether the Fed raises rates in September or later doesn't seem to be the key question at this point. The focus should be more on how quickly they raise rates and what the ultimate level is. Yellen has been very cautious so far, and we think this continues once the rate hikes begin. The big debate for bonds is whether the long end of the curve will see big rate increases when the Fed tightens. Every prior rate tightening cycle has resulted in rising long rates (at least initially). Is this time different? Maybe. This is because of what is going on with the rest of the world. Relative to the size of the European public debt market, Europe's quantitative easing program dwarfs the size of the recent U.S. program and has helped drive yields in many countries to negative levels on a nominal basis. The real interest rate differential of German bonds is at historic levels compared to the equivalent U.S. Treasury. On a relative basis, the U.S. bond market looks wildly attractive and any meaningful increase in rates may be met with strong flow from foreign investors. Thus, long rates could remain fairly steady with a yield curve that flattens. We believe that long rates will rise, but not much until global bond rates recover somewhat as well – perhaps when around the time that the ECB's current quantitative easing program is expected to end in September of 2016.

From a global standpoint, not a whole lot has changed. Europe is getting a little better with bumps along the way. The big near-term headache in Europe is our favorite fiscal stalwart, Greece. In a bow to his waning constituency, Prime Minister Tsipras seems to be playing a game of chicken with creditors. While he agreed to a framework for reforms back in February, he doesn't seem willing to enact viable solutions. Without some sort of deal, Greece will surely run out of money by June (if not sooner) and the current deal deadline set by negotiators is May 11th. I think that as we approach the new deadline, the rhetoric and posturing could get worse causing meaningful market movements, but ultimately some sort of patchwork agreement gets done. Tsipras would be shooting himself in the foot as most Greeks want to remain in the EU and the economic fallout would likely be dire in the end. Besides the Greek headache and the fact that Ukraine never fully goes away, Europe is definitely improving. Germany just raised its GDP forecast and is even seeing solid wage growth while key reforms are starting to boost Spain and Portugal. France remains lackluster. When looking at ISI econometric modeling, EU's implied GDP growth is basically growing in line with the United States. From an investment standpoint, Europe is intriguing given its relative valuation and improving trends, but the currency risk is likely to remain a headwind.

The Chinese ship is slowly sinking. On the surface, the deceleration in GDP growth to 7% seems to be a fairly soft landing, but we think this headline number is masking the true weakness. A variety of indicators such as third-party PMIs and electricity usage suggest the real growth could be half of the reported number. The fact that the Central Bank has been easing is all the more indicative of the true economic growth. We think it is important to recognize that China has been propped up tremendously over the last seven years by incremental debt. Since 2007, China has added $21 trillion to its total debt, which combines government and household debt. Yes, $21 trillion. If you look at 2007 as a baseline, the entire economy only added $25 trillion in cumulative GDP. Now that total debt in China exceeds the United States as a percent of GDP, we think this game will end sooner rather than later. They have been pumping up the economy with debt-induced investment and when the credit slows down, the growth may fall much further. Yet, this debt game could still continue on for a few years, so we don't think it is worth panicking. Rather, we are generally avoiding China and will continue to monitor it closely. The recent spike in its equity markets only creates another possibility for economic dislocation when the bubble pops.

Back to the original question about the U.S. stock market in light of an earnings recession, we do feel as though it will be difficult for the market to make significant advances this year. Doing so would involve meaningful multiple expansion which just doesn’t seem likely at the beginning of a rate tightening cycle. On the other hand, if the U.S. economy remains strong, there doesn’t appear to be a ton of downside either. As we get into the second half, investors will probably begin to look toward 2016 when earnings growth will likely return and it could provide a decent fourth quarter market return. In the meantime, we think that there will be opportunities to beat the benchmark as the market muddles through. Multinationals with heavy foreign exposure are going to struggle, while smaller domestically oriented names should be superior. We also think the eventual oil tailwind will find its way back into retail spending so Consumer Discretionary stocks could perform as well. As such, our portfolios are currently positioned toward these areas while maintaining some cash to take advantage of any pullbacks. It seems unlikely that the market will “run away from us”, so selling at the top of the trading range and buying at the bottom is effective.