EPIC INVESTMENT MANAGEMENT

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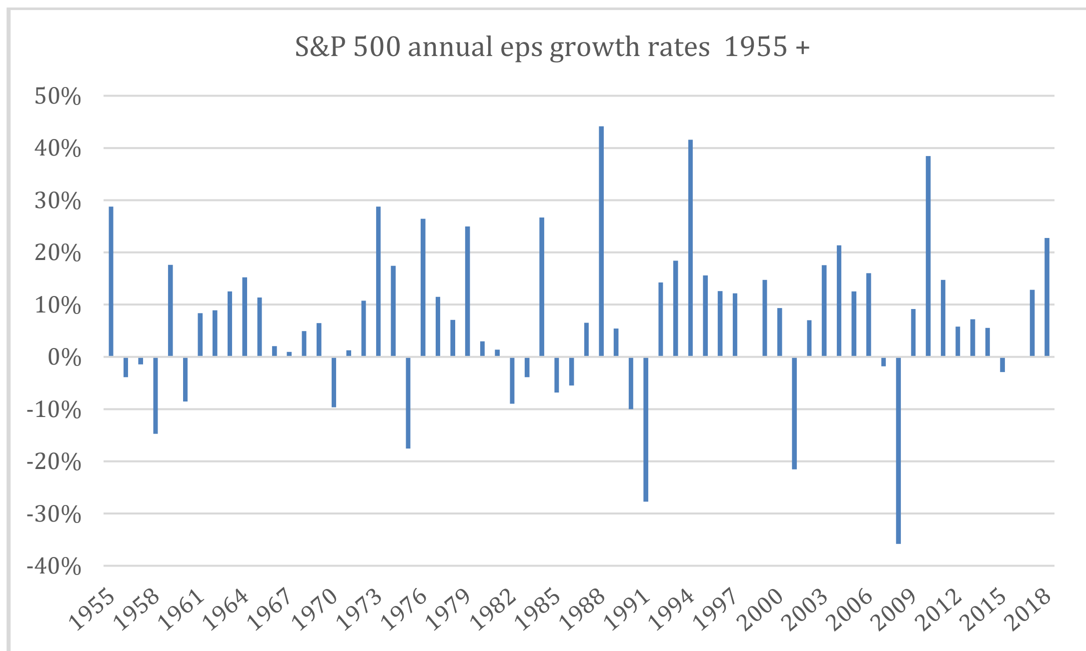
The Earnings Conundrum

We should all be forgiven at being surprised by 2018. Jump-started by revived economic growth and turbo-charged by a historic corporate tax rate reduction, S&P 500 earnings per share growth accelerated to 23 percent for the year. This marked the fastest growth since 2010, and nearly four times the long-term annual compound growth rate over the past 64 years.

Moreover, in the few prior years of 20 percent or better earnings growth, stocks rose eight times out of nine. In 2018, it did not matter, as equities and most other asset prices declined. Sometimes, the odds are in your favor, and you still lose out.

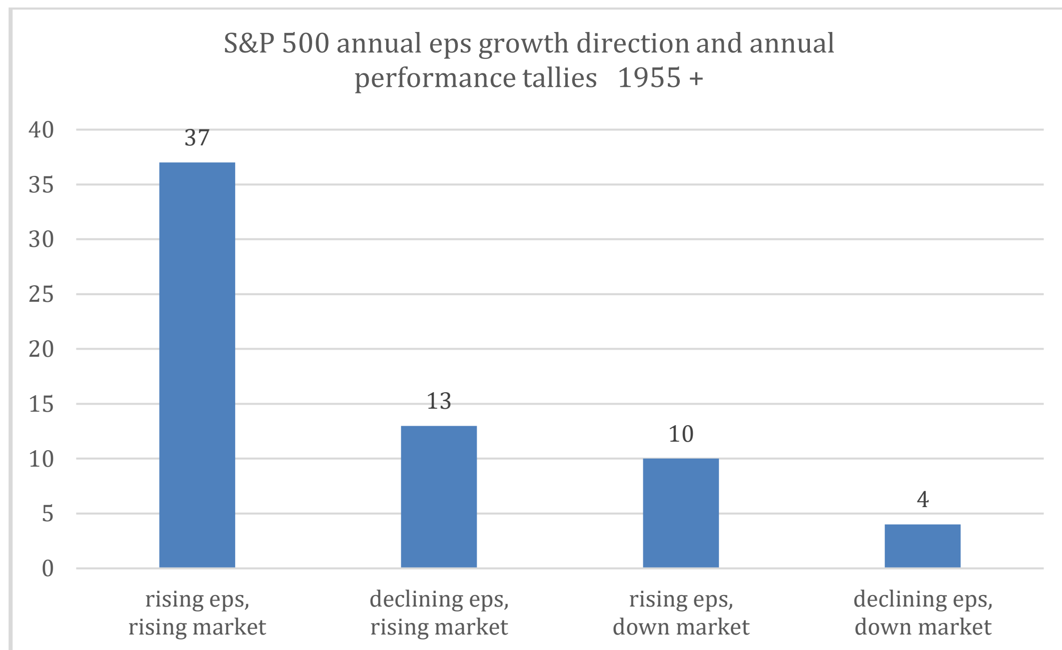


So, if stocks could not advance with a gale-force wind at their back, what hope do we hold out for this year, with earnings growth expected to be either side of zero?

Well, as it ends up, we should expect plenty. As shown below, to no one's surprise, the most common

annual occurrence is for rising earnings and rising stock prices. From here is gets more interesting, as the second most common outcome is a rising market in the face of declining profits. And what investors intuitively fear most -- a market decline coinciding with an earnings recession -- has occurred just four times in the past 64 years.

Something seems amiss.



According to a recent Wall Street Journal article, these past 64 years are no anomaly…

> "Looking at 145 years of U.S. stock-market history collected by Yale University Prof. Robert Shiller, reported earnings moved in a different direction than stocks in 55 years. Even when they moved in the same direction, the gaps were often vast, as with 1997's 31 percent gain in the S&P when earnings rose less than 3 percent.
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> Of course, investors attempt to anticipate earnings. One might think that what really matters isn't earnings, but earnings expectations, proxied by the consensus forecast of analysts.
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> Surprisingly, changes in earnings estimates are as useless as changes in trailing earnings for forecasting price moves over the earnings season. Since 1985, the U.S. market and 12-month forward earnings estimates have moved in different directions in almost one in three quarters.
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> Stocks also tend to do really badly when earnings collapse, typically in recessions. From its peak in September, the consensus for 2019 S&P earnings is down 4.5 percent, and could fall

> much further if the economy is in deeper trouble than most think or if wage rises crimp profit margins.
>
> But earnings for 2012, 2013, 2015, 2016 and 2017 all dropped faster over similarly short periods, without derailing the bull market. Investors should focus on future prospects first, and near-term earnings second."

We already know that, barring a recession, there is little connection between economic growth and stock prices. At times our economy runs too hot, while stocks cool off in concern for what lies ahead. At other times, it is the exact opposite, and we attribute a strong market move to a "goldilocks" environment. Now we are led to believe that, not only does our economy matter little, neither does the profit picture.

Yet, as we write this, we are also keenly aware that nothing is more important over a long-term horizon than earnings growth. Exasperated yet?

S&P 500 eps and S&P 500 price, both indexed to 1, log scale

$100
$10
$1
1954 1959 1964 1969 1974 1979 1984 1989 1994 1999 2004 2009 2014 2019
sp 500 eps
sp 500 index

There are two problematic conditions in any objective analytical exercise. The first is a theory without data. The second, applicable here, is data without a theory. How do we explain that the most important driver of long-term equity returns is all but inconsequential to short-term results, running as long as a year or more?

Create a theory to fit the data, applying an inelegant form of reverse engineering.

The best explanation for this quirky behavior is that the market is a discounting mechanism, looking further into the future than many of its participants. If stocks rise into declining earnings it is because the market a) has already priced in the weak profit picture, or b) foresees better earnings in the years ahead, or c) is applying a lower discount rate to earnings, driving valuations higher in the face of bad news.

If this rationale makes sense yet still leaves us wanting, in that it provides no clear-cut decision rule for investors facing an earnings slump, join the crowd; there is no obvious decision rule.

Since 1955, there have been 13 years wherein the S&P 500 rose while earnings declined, including a tight cluster in 1982, 1983, 1985 and 1986. In this multi-year episode, our economy was at the dawn of its renaissance, breaking from the widespread malaise and high inflation of the prior decade. Stock prices soared as the powerful forces of disinflation, falling interest rates and rising production overwhelmed any near-term profit concerns. And it certainly helped that equities started this upcycle at near historic-low valuations, providing room for price-to-earnings multiples to double over this timeframe. That explains four of the 13 oddly-performing years.

In other episodes, an earnings decline was priced into stocks the previous year, including the recession bear markets of 1973-74 and 1990. In these cases, profit expectations drove stocks lower, but the timing was out of sync; the recessions and market declines came first, the profit slump a year later. This explains two more anomalous years.

That still leaves us with seven years of head-scratching market moves -- falling profits and rising stock prices -- without explanation. What to do, short of throwing our hands in the air in surrender to the inconsistency of it all?

Lacking more convincing explanations, we must accept that earnings are critically important to long-term equity performance, and at the same time can be minimally important to short-term stock prices. And we never know when this rule will apply.

Merriam-Webster defines “conundrum” as a) an intricate and difficult problem, or b) a question or problem having only a conjectural answer. Perhaps for future reference they will include “see earnings growth and stock prices”.

In Search of Intelligent Life

Silly season seems to start earlier as the years go by. Case in point, Democrats -- some running for the White House, others just running their mouths -- trying to one-up each other in a lurch to the left. While we generally steer clear of pure political banter, many of these recently-espoused ideas are dangerous to our economy and our ideals as a free, capitalist society.

Let's start with the newfound media darling, first-term US Representative Alexandria Ocasio-Cortez. Ms Ocasio-Cortez offers something for everyone. To the left, she is a fresh new face fighting for truth, justice and an American way of self-promotion. To the right, she is exhibit one under the heading "never underestimate the stupidity of the American people." In any case, neither side can get enough of her.

Among the bright ideas of this bartender-turned-sage is her proposal to create a 70 percent tax bracket on incomes over 10 million dollars, a creative idea other than its naiveite and obvious demagoguery. As she explains, "I do think a system that allows billionaires to exist when there are parts of Alabama where people are still getting ringworm because they don't have access to public health is wrong."

Well, well, well. We should ban itchy fungal infections, probably as common in the Downtown Athletic Club of New York as in the streets of Birmingham. We might as well toss in tinea pedis (athlete's foot) and tinea capitis (ringworm of the scalp). And for the Congresswoman's clarification, there is no worm in any of these, just as there are no ear parts in Orecchiette pasta, nor blood in Sangria.

On the tax issue, according to the once-venerable source CNN, "the proposal, which would only affect fewer than one in every 1,000 households, has sparked a long overdue discussion about taxing the wealthy. Raising taxes on the rich is the right idea at the right time, but some ways to do so are better than others."

Not content with that tepid endorsement, Ms Ocasio-Cortez, the youngest woman ever elected to Congress, raised the stakes by declaring, "the world is going to end in 12 years if we don't address climate change." She then doubled down by calling the fight to mitigate the effects of climate change her generation's "World War II". Send in the Marines.

This is all prelude to the big enchilada, what the freshman Congresswoman has labeled the "Green New Deal".

While the slogan may be catchy and nostalgic -- if you have fond memories of the Great Depression and the run-up to World War II -- the details of the Green New Deal remain a work in progress. In its recent iteration, the plan would slash the military in half, eliminate natural gas and coal-based energy, and ban gasoline-powered vehicles, all in the name of a zero-emissions economy. Meanwhile, China and India will eat our lunch while burning all the carbon their economies desire. We might as well keep going, all the way back to the stone age.

And it doesn't stop there. The Green New Deal piles on with universal health care, guaranteed jobs for all, paid family leave, paid vacations, refurbishing every building in the country to meet new environmental standards, and eliminating nuclear power.

As for the cost, estimates seem to rise every week, now approaching 100 trillion dollars, five times our nation's annual economic output.

And just as we should never underestimate the stupidity of the American people, we must never be surprised that politicians will insult our intelligence in search of campaign funds and election votes.

One voice of reason comes from Microsoft co-founder and philanthropist Bill Gates, who says, "It's not realistic to think that people will simply stop using fertilizer, running cargo ships, building offices, or flying airplanes. Nor is it fair to ask developing countries to curtail their growth for the sake of everyone else."

In other words, the stone age has limited appeal.

At last count, nearly every Democrat hopeful for the 2020 Presential race supports this idea.

Next in line is Senator Elizabeth Warren of Massachusetts, proposing a wealth tax on citizens whose net worth exceeds 50 million dollars.

According to the Senator:
"The top 0.1 percent of American families -- the richest 1 in 1,000 -- now have nearly the same amount of wealth as the bottom 90 percent of American families combined. Meanwhile, for everyone else, opportunity is slipping away."

Ms Warren's plan would require the top 75,000 households to pay an annual tax of two percent on each dollar of their net worth above 50 million dollars. It would rise to three percent on every dollar above one billion dollars.

The Senator said she would use the revenue to rebuild the middle class, potentially by using the money to pay for child care or relieve student debt.

This proposal gives us two immediate insights: Ms Warren's net worth is less than 50 million dollars; and she has not read the Constitution, which allows for federal taxes on income and levying of tariffs, but no taxation of assets.

Pesky details, that Constitution.

Finally, there is the dynamic duo of Senators Chuck Schumer and Bernie Sanders. In a recent op-ed piece to The New York Times, excerpted here, they write:

> "… over the past several decades, corporate boardrooms have become obsessed with maximizing only shareholder earnings to the detriment of workers and the long-term strength of their companies, helping to create the worst level of income inequality in decades.
>
> One way in which this pervasive corporate ethos manifests itself is the explosion of stock buybacks. So focused on shareholder value, companies, rather than investing in ways to make their businesses more resilient or their workers more productive, have been dedicating ever larger shares of their profits to dividends and corporate share repurchases. When a company purchases its own stock back, it reduces the number of publicly traded shares, boosting the value of the stock to the benefit of shareholders and corporate leadership.
>
> This practice of corporate self-indulgence is not new, but it's grown enormously. Fueled by the Trump tax cut, in 2018, United States corporations repurchased more than $1 trillion of their own stock, a staggering figure and the highest amount ever authorized in a single year.
>
> This has become an enormous problem for workers and for the long-term strength of the economy for two main reasons.
>
> First, stock buybacks don't benefit the vast majority of Americans. That's because large stockholders tend to be wealthier. Nearly 85 percent of all stocks owned by Americans belong to the wealthiest 10 percent of households. Of course, many corporate executives are compensated through stock-based pay. So when a company buys back its stock, boosting its value, the benefits go overwhelmingly to shareholders and executives, not workers.
>
> Second, when corporations direct resources to buy back shares on this scale, they restrain their capacity to reinvest profits more meaningfully in the company in terms of R&D, equipment, higher wages, paid medical leave, retirement benefits and worker retraining.
>
> At a time of huge income and wealth inequality, Americans should be outraged that these profitable corporations are laying off workers while spending billions of dollars to boost their stock's value to further enrich the wealthy few. If corporations continue to purchase their own stock at this rate, income disparities will continue to grow, productivity will suffer, the long-term strength of companies will diminish -- and the American worker will fall further behind.
>
> That is why we are planning to introduce bold legislation to address this crisis. Our bill will prohibit a corporation from buying back its own stock unless it invests in workers and communities first, including things like paying all workers at least 15 dollars an hour, providing seven days of paid sick leave, and offering decent pensions and more reliable health benefits.

In other words, our legislation would set minimum requirements for corporate investment in workers and the long-term strength of the company as a *precondition* for a corporation entering into a share buyback plan. The goal is to curtail the overreliance on buybacks while also incentivizing the productive investment of corporate capital.

Some may argue that if Congress limits stock buybacks, corporations could shift to issuing larger dividends. This is a valid concern -- and we should also seriously consider policies to limit the payout of dividends, perhaps through the tax code."

Whew, that is an earful. Yet, seldom have two men of such high stature ever been so uniformly wrong. Let's highlight a few problems.

First, it is true that the average American worker has been left behind, sinking slowly but surely from the middle class. This is why an outsider, a non-politician, was elected President. And whether you adore Mr. Trump or abhor him, it does not change the fact that the widest income disparity in modern America was recorded during the Obama years, and nobody blamed share buybacks. Nor is it clear why anyone would whine about corporate layoffs. After all, the unemployment rate is under four percent, nearing five-decade lows; while the number of job openings in the US exceeds all out-of-work laborers. As Casey Stengel was fond of saying, "you could look it up."

Next up is the concern over research and development(R&D) spending, the lifeblood of innovation in corporate America. If the good Senators are to be believed, companies have been skimping on R&D, in favor of share repurchases. Nonsense. A Goldman Sachs study reveals that R&D spending by S&P 500 companies is at the highest proportion of sales since at least 1990. Overall business R&D in the US is the highest percentage of Gross Domestic Product since the government started tracking it in 1959. If R&D spending is a problem, contrary to the Senators' complaint, it appears to be excessive.

And what about capital spending? According to a report by Tobias Levkovich, Citigroup's chief US equity strategist, capital expenditures set a record high in 2018, breaking the prior record from 2014. As Mr. Levkovich explains, "Investors have been fed a misleading narrative" that companies are forgoing investments in their business to buy back stock.

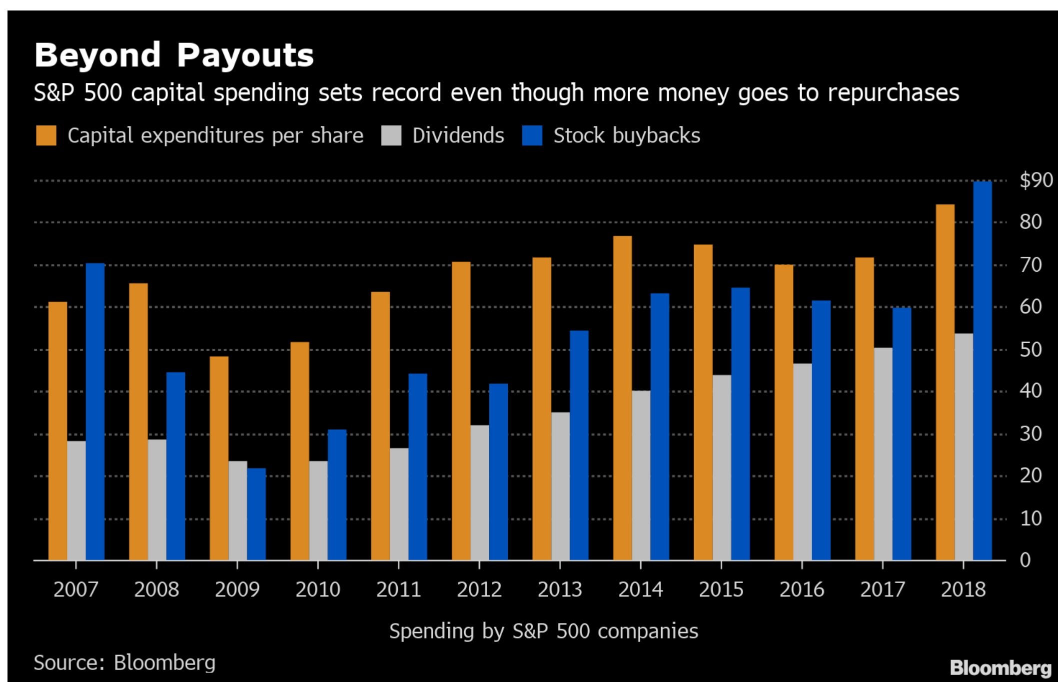
Okay, maybe it is the public markets as a whole that create the problem. Well, maybe not. As reported by Bloomberg's Peter Orszag,

"Recent US Federal Reserve research suggests that public firms are actually more likely to invest for the long term than their private counterparts.

The researchers examined corporate tax returns filed from 2004 to 2015. Tax returns, which are generally not available except under special circumstances, gave the researchers important information that would have been hard to obtain elsewhere. They included financial data of private firms, for example, and contained detailed enough information to separate short-term investments from long-term ones. Also, the sample of companies was not selective, since all firms must file tax returns.

Their findings were striking and surprising. Compared to otherwise similar private firms, publicly listed companies invested almost 50 percentage points more as a share of their assets. Most of the difference was due to long-term investments, and especially to R&D.

As the study noted:
It is not simply that public firms invest more relative to their asset base and thus out-invest private firms, they also direct a greater share of their investment portfolios to long-term assets. Public firms allocate nine percentage points more of their total investment dollars to long-term assets than comparable private firms. The long-term investment advantage of public firms over private firms largely stems from their outsized investments in R&D. Public firms invest 39.2 percentage points more in R&D expenditures relative to physical assets, and dedicate 11 percentage points more of their investment budgets towards R&D than private firms."



If Senators Schumer and Sanders make an impassioned plea, it is also a flawed one. In any competitive business, when a company forsakes its future -- by skimping on research and development, or on capital spending, or on investing in its workforce -- the business will be trampled by its competitors, relegated to bankruptcy watch or just plain irrelevance. Consider Sears, once the world's largest retailer, now in bankruptcy. Or Yahoo and other search engines, supplanted by Google. MySpace was over-run by Facebook. IBM once was the world's leading tech company. AT&T and Xerox were considered blue chips. The list goes on and on.

And if the Senators do not grasp this aspect of American capitalism, perhaps they can understand this much: the facts contradict their outrageous claims.

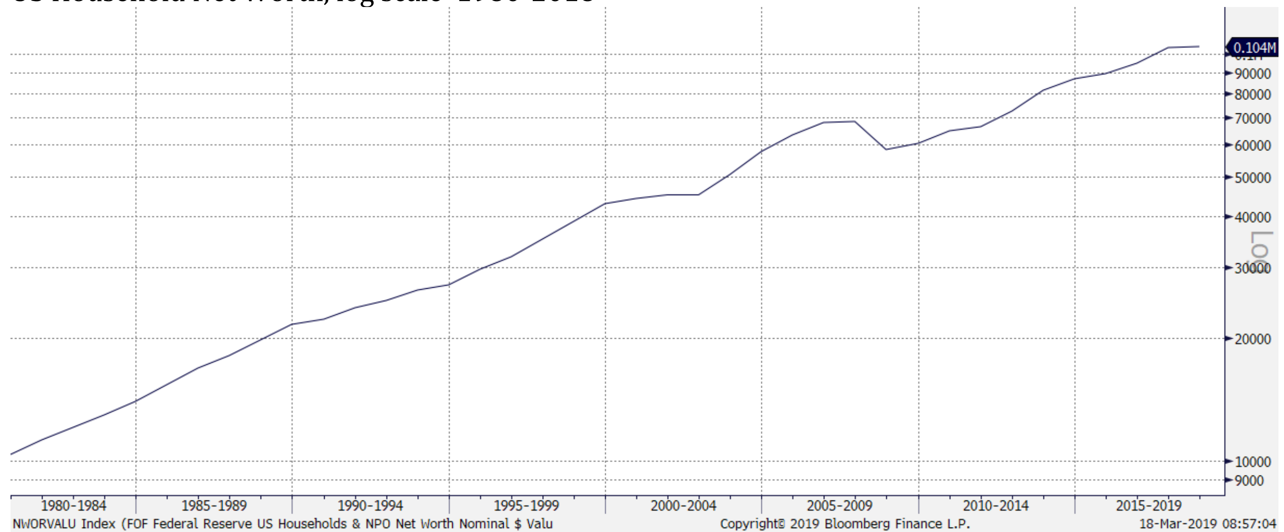
Chart du Mois

Want to win a bet? Ask anyone to estimate aggregate US household net worth -- that is, the value of all household ownership of stocks, bonds, cash, housing, cars, boats, art work, gold coins, jewelry, and anything else Americans may own; net of all household debt, including mortgages, student loans, auto loans, and credit card debt.

Take a guess. Even if you show them this chart, people are unlikely to properly measure its scale. It totals 104 trillion dollars, nearly doubling since the trough of the global financial crisis.

A decade ago, the Federal Reserve set out to support asset values through its aggressive monetary policy, namely zero interest rates and Quantitative Easing. The Fed should take a bow, it succeeded.

US Household Net Worth, log scale 1980-2018



Words of Wisdom

Charlie Munger, vice-Chairman of Berkshire Hathaway and long-time business associate of Warren Buffett, in a recent interview on CNBC, on the growing anti-wealthy sentiment in parts of the US:

"The idea that you're gonna help New York by driving the rich people out, of course it hurts New York. And of course, it hurt Connecticut. The idea of that beautiful real estate in Connecticut, down 50 percent in value; they've driven out all the rich people.

And California's doing the same thing. I know a lot of rich people who left California. I think it's really stupid for a state to drive the rich people out. They're old. They keep your hospitals busy(chuckle). They don't burden your schools, the police department, your prisons. They give a lot. Who wouldn't want rich people?"

Tidbits...

International Monetary Fund, OECD, cut global growth forecasts for 2019, expect slowest expansion in three years, highlight weakness in Europe.

Federal Reserve signals more dovish policy, including freeze on rate hikes and end of balance sheet run-off.

US economy grows 2.9 percent in 2018, matches fastest growth in a decade.
US unemployment rate drops to 3.8 percent, nears 50-year low.
US wages grow at 3.4 percent annual rate, highest since 2009.
US household debt burden drops to lowest level in four decades of Federal Reserve data.
And what exactly is the problem?

China's trade surplus with US rises 17 percent in 2018 to 323 billion dollars, record level.
US trade deficit widens to 621 billion dollars in 2018, 10-year high, despite White House efforts on trade reform.

PG&E Corp, California utility facing massive liability related to wildfires, declares bankruptcy.

US existing home sales drop to three-year low as housing market weakness deepens.
US home prices for 2018 rise at slowest rate in four years, under five percent.

Germany targets eliminating all coal-fired power plants by year 2038, with shift to renewables.
US carbon emissions rise 3.4 percent in 2018 after three years of decline; strong economy cited as the culprit.
US oil imports fall to lowest level since 1996 as domestic production hits 12 million barrels per day.

Walmart, struggling to secure supply lines, to pay its truckers an average of 87,000 dollars per year.

US Treasury debt sets dubious record, surpasses 22 trillion dollars.
No end in sight.

Amazon backs out of New York City headquarters agreement after political backlash over incentives.

Samsung unveils foldable smartphone, at a price of 1,980 dollars; Huawei prices its model at 2,600 dollars.

US Chamber of Commerce advocates a more-than-doubling of federal gasoline tax over next five years, citing infrastructure needs.
The only 'good' tax we pay.

US Justice Department files court motion for Affordable Care Act, aka Obamacare, to be struck down in its entirety.
To be replaced by what?

Source:
Bloomberg
CNBC
CNN
Mayoclinic.org
Merriam-Webster
Patriot Post
The New York Times
The Wall Street Journal