Issue 40 March 2017

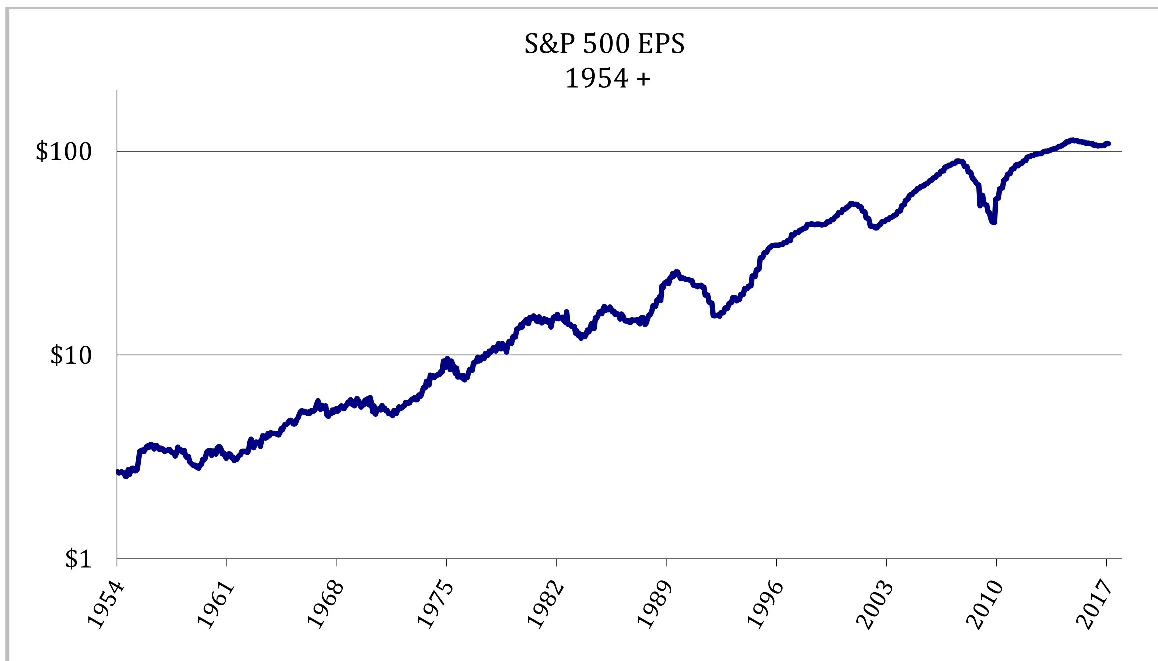
Earnings Revival

This deep into an economic cycle, it is probably a leap too far to declare "all clear" on the outlook for corporate profits. There are simply too many potential pitfalls nearly eight years into expansion, among them a strong US dollar, slowing revenues, rising interest costs, higher wages, and an outright recession.

So we take the leap with some trepidation. All clear.

Let's start with the long view.

Since 1954, using adjusted earnings per share, profits on the S&P 500 index have grown from under three dollars to nearly 114 dollars, a compound annual growth rate of six percent.



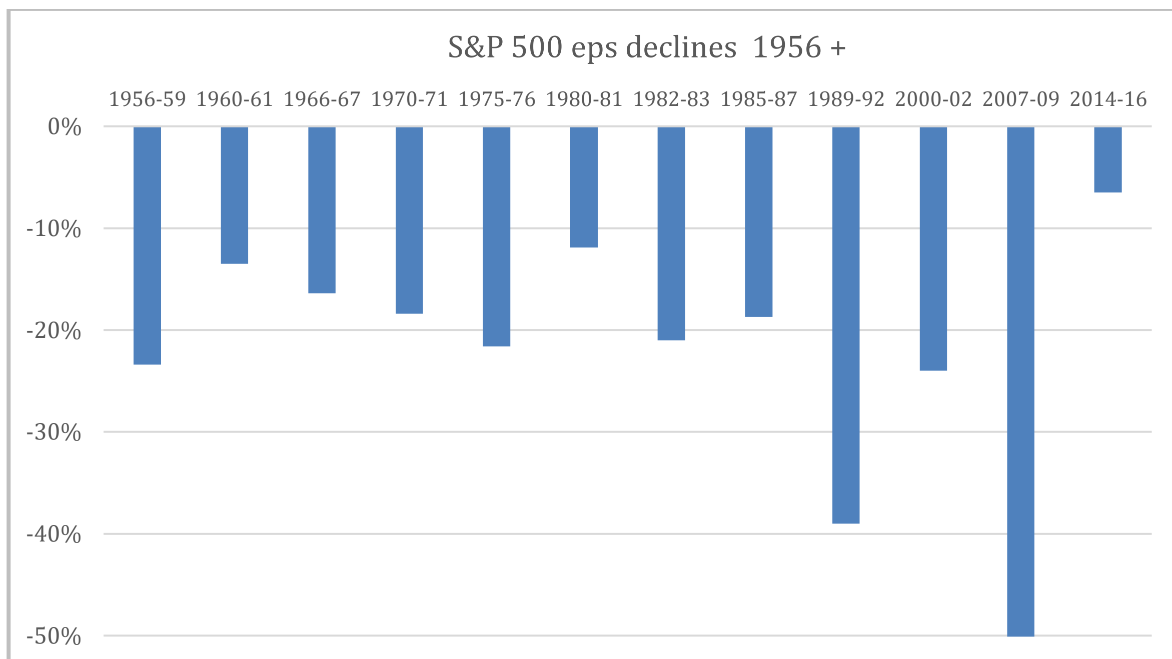
Life would be easy if we could simply assume six percent growth every year. Unfortunately, corporate profits have their own cycles, often coincident with economic trends, but not always so.

Thus the current worry that S&P 500 earnings, near an all-time high, represent a cycle peak. If this is the case, with stock prices setting records, investors are certainly not prepared for what may follow.

For the time being, this concern is overblown.

Here's why.

Based on the same S&P 500 earnings history, corporate America just experienced the most benign profit recession in six decades. Between November of 2014 and June of 2016, profits fell from 114 dollars to 106 dollars, a year-and-a-half-long decline measuring seven percent. As shown below, the second mildest earnings recession, in 1980-81, was nearly twice as severe.



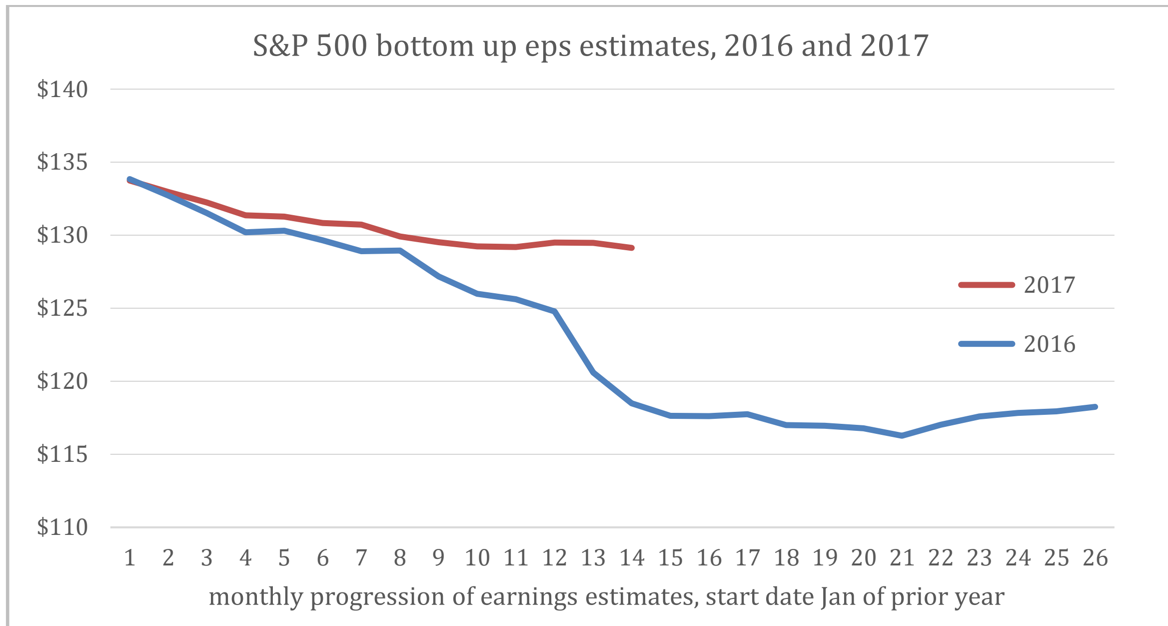
And now the trend is reversing.

Since the June 2016 trough, 12-month earnings per share have climbed back to 108 dollars, up two percent, and are almost certainly heading higher. Qualitatively, the reasons include a recovery in the oil patch, a more stable US dollar, and accelerating domestic and global growth. This assessment ignores the benefit of a corporate tax cut, though such a cut seems likely.

Quantitatively, we can see the recovery in analyst earnings estimates, but to do so we need to transition from the more conservative adjusted earnings per share used above, to Wall Street's more aggressive game of measuring "earnings before all the bad stuff". As we make this shift, the earnings figures that follow will not match up with the numbers cited above.

The 2016 bottom-up estimate for S&P 500 earnings is provided as a benchmark for profit trends at this time of year. The typical pattern is for analysts to take an optimistic early view of future earnings, in this case starting one year prior to the actual measurement period.

As time passes and reality sets in, forecasts are cut; and for 2016, the cuts were deep. By this time last year, profit estimates had fallen 11 percent from their starting point of a year earlier. This declining forecast was extreme in its magnitude, yet typical in its seasonal pattern. Early in any calendar year, as companies update guidance and analysts sharpen their pencils, estimate cuts are the norm.



The early trend for 2017 is much more encouraging. Instead of an 11 percent reduction in earnings estimates, the tally measures less than four percent. Even if we conservatively slash another four percent from these estimates, earnings will grow five percent year over year, without the benefit of corporate tax cuts.

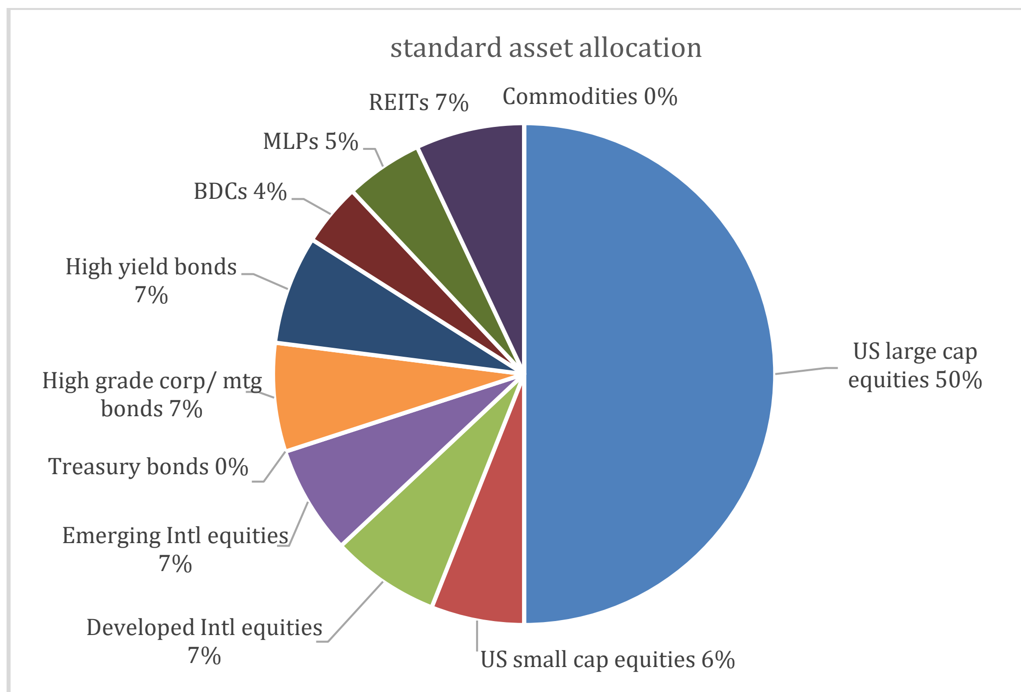
Our best guess is that we have survived a mild profit recession, to be followed by a meaningful earnings recovery. The benefits of fiscal stimulus may be partially baked into these numbers, but corporate tax cuts certainly are not.

Great again, or not, corporate America is back on its feet. The profit recession is over. Bring on the revival.

Portfolio Update

The chart below offers a visual representation of our standard asset allocation in client portfolios. Standard, not typical, assumes all asset classes are in a state of equilibrium, wherein their pricing, quality, and projected growth rates are near what might be described as average or normal levels. Considering that 11 asset classes are represented, and that financial markets are always in a state of flux, 'standard' is a condition rarely, if ever, seen.

Nevertheless, portfolio construction must begin somewhere. For Epic, it starts with a focus on equities, particularly US-based large-cap equities. As we have long noted, equities have historically provided investment returns well above those of other asset classes, including bonds, bills and commodities. Thus the equity focus. Alternative assets are included to provide diversification, current income, reduced volatility, and to selectively participate in attractive opportunities as they arise.

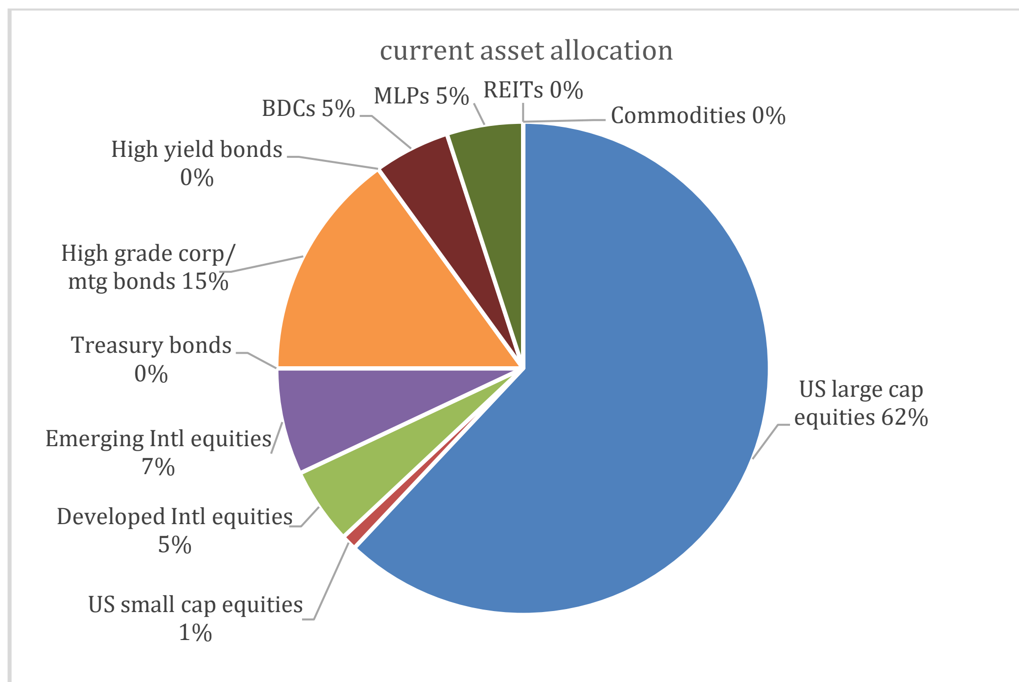


For clarification...
BDC stands for Business Development Company
MLP stands for Master Limited Partnership, in our case with a focus on energy infrastructure
REIT stands for Real Estate Investment Trust

All three serve as income/ yield alternatives, with tax-advantaged structures at the corporate level, high current-income streams paid to shareholders, and daily trading liquidity.

Note that Treasury bonds and commodities carry a standard allocation of zero. In most market environments, we prefer the higher yields of investment-grade corporate debt, mortgage debt, and high-yield bonds. While these carry more risk than government bonds, they typically reward investors with higher returns. And in almost every scenario, they are all less risky than equities. Pure-play commodities, including gold, silver, oil, industrial metals and agricultural products rank among the least rewarding investments over a long-term horizon. To overly simplify, they sell at zero yields and infinite price-earnings multiples; they also serve as a reminder that the term 'commoditized' is an investment pejorative.

Below is our current portfolio positioning, give or take a few percentage points of variation from one client account to another, and temporary cash holdings.



Our overall equity position is above the standard allocation, reflecting our belief that equities are still more attractively priced compared to bonds and other assets. It's a relative value game, as opposed to a table-pounding endorsement. Truth is, there are few cheap assets in today's financial markets.

We hold no positions in high yield bonds or REITs, viewing both as poor risk-reward trade-offs at current prices. The allocation from these assets has essentially been shifted to high grade and mortgage bonds, in the form of exchange-traded funds and mutual funds, and to equities.

One final thought… cash is not listed as an asset class. Certainly, account cash levels will rise and fall as we sell some holdings and re-invest in others. But this is a short-term, transitional condition. Over a market cycle, investment returns suffer from accounts holding excessive cash, and with 11 assets to choose from, we should generally find something we want to own.

This general rule is flipped on its head in severe market downturns, where cash becomes a safe haven. If we have the foresight to anticipate such a downturn, we will become hoarders of cash. The problem is one of timing, and our crystal ball is no clearer than anyone else's. Sorry, no guarantees on this one.

Banking On Better Policy

Reprinted from BloombergBusinessweek December 22, 2016
Jamie Dimon, CEO of JPMorgan Chase, in an interview with Megan Murphy

The Republicans are in charge, and they have not been anti-business the way you've seen the Democrats largely be anti-business for years. I think if you are going to be president, you should have the best people sitting around a table. I think it's a mistake for the American public to constantly be told that if you work for an oil company or you work for a bank, that automatically makes you bad. I think a lot of these people are very qualified people who are patriots. They're going to want to help the country. They're not going to try to help their former company. These are people with deep knowledge that will hopefully do a great job.

I think it's a reset moment for how businesses are going to be treated: 145 million people work in America; 125 million of them work for private enterprise; 20 million work for government -- firemen, sanitation, police, teachers. We hold them in very high regard. But you know, if you didn't have the 125 you couldn't pay for the other 20. Business is a huge positive element in society. But for years it's been beaten down as if we're terrible people. So I think it's a good reset.

Re-printed from Yahoo Finance article by Sam Ro June 17, 2016

In a note to clients on Friday, CitiFX analyst Gregory Marks considers the experience of Rudolf von Havenstein, president of Germany's Reichsbank from 1908 to 1923:

"During Havenstein's time at the Reichsbank, it was widely believed that the rate of inflation and the money supply had nothing to do with each other," Marks wrote. "For some context, the gold standard was suspended during WWI and Keiser Wilhelm II did not enact an income tax (unlike France) to pay for the war, choosing to pay by borrowing. The war was lost and over with, but the debt remained. In order to 'help' the government and people, old Havenstein went on a printing spree.

Good idea right? Remember, at that time it was believed that the rate of inflation and the money supply had nothing to do with each other. The end result was crippling hyperinflation, economic collapse and a negative shift in the political spectrum."

The structure of this thought experiment is a popular one. At various points in history, the world was flat, earth revolved around the sun, and bread was good for you. All of those ideas were later proven to be at least somewhat flawed.

"[W]e should be invoking Havenstein to identify the present flaw in institutional thinking around current monetary policy, specifically negative rates," Marks added. "In other words, the lesson here is that, unfortunately, people believed in the efficacy of a completely irrational policy because it was put in place by a qualified and experienced policymaker, this instead of questioning the

common sense merit of its possible outcome."

Long-term interest rates are negative in Switzerland and Germany. Meanwhile, rates in the US remain historically low. And central bankers around the world haven't ruled out the possibility that rates could go even lower.

"There are laws that prevent the medical industry from adopting experimental procedures before they become, well, less experimental," Marks noted. "To not have those laws in place would be dangerous. Experimental procedures can produce unintended consequences and their efficacy must be rigorously tested before wide release and adoption. So as a society, we do not let doctors perform experimental procedures on everyone who walks through the hospital doors."

"Yet for some reason, there are a lot of PhD holders from a different industry who are doing just that to entire nations and economic zones. This isn't a theoretical petri dish. It's the global economy."

Source:
Bloomberg
The Wall Street Journal
Yahoo Finance

Tidbits..

Finland experiments with "universal basic income" payment to small number of citizens, who receive government stipends regardless of work status.

With start of new year, OPEC, Russia and others begin oil production cuts. Oil prices double off 2016 bottom.

Ford Motor cancels plans for billion-dollar auto plant in Mexico, to shift investment to Michigan.
Fiat Chrysler to invest one billion dollars, add 2,000 jobs in Michigan and Ohio auto plants.
Toyota Motor announces 10 billion-dollar US expansion.
General Motors to invest one billion dollars in US production plants, add 5,000 domestic jobs.
Hyundai-Kia plans to spend three billion dollars in US business over next five years.

How many anecdotes before a trend is established?

Average hourly wages in US rise by 2.8 percent year over year, fastest pace since 2009.
US GDP grows at 1.6 percent rate in 2016.
US trade deficit rises to 502 billion dollars in 2016, largest in four years.
Consumer Confidence climbs to highest level since 2001.

Volkswagen pleads guilty to US charges in emissions cheating scandal; employees face indictment, extradition to US.
Environmental Protection Agency accuses Fiat Chrysler of similar diesel emissions cheating.
France opens investigation of Renault for emissions fraud.
Takata pleads guilty, agrees to billion-dollar settlement over defective airbag systems; executives face US criminal charges.

Still looking for clean-diesel technology, reputable auto management.

Macy's, J.C. Penney announce plans to accelerate store closings, job cuts.
Limited Stores closes all brick and mortar locations, files bankruptcy, plans to sell exclusively online.

A retail disaster area, with no relief in sight.

Trump Administration orders US withdrawal from Trans-Pacific Partnership trade deal.
White House signs orders to advance Keystone XL and Dakota Access energy pipelines.

Proposed healthcare mergers of Aetna and Humana, Anthem and Cigna, are blocked by courts on anti-competitive grounds.
Humana announces plans to withdraw from Obamacare marketplace in 2018.
Aetna Chief Executive says Obamacare marketplace is in a "death spiral".

Union membership in US falls to record low, 11 percent of workers.

The Greatest Show On Earth -- Ringling Bros. and Barnum & Bailey Circus -- to fold up its tent after 146 years.