EPIC
INVESTMENT MANAGEMENT

Issue 29 May 2015

Profits On Pause

Something is amiss. The oftentimes loose connections between America's real economy and its financial markets are no longer loose. They are disconnected.

Thank goodness.

The Citigroup Economic Surprise Index tracks economic data compared to expectations. While we can be skeptical about the usefulness of any particular prognostication -- who makes guesses on import prices, or factory orders? -- in aggregate the series gives a fair representation of our economy's momentum.

What the index shows for the first four months of the year is disheartening for main street America. Starting at a near-term peak in late December, the index dropped from a respectable value of plus 40, to a nearly four-year low of minus 73, before rebounding slightly. Blame it on the weather -- winter showed up again this year; blame it on the west coast port strike; blame it on oil prices or the strong dollar. Take your pick, the numbers don't lie.

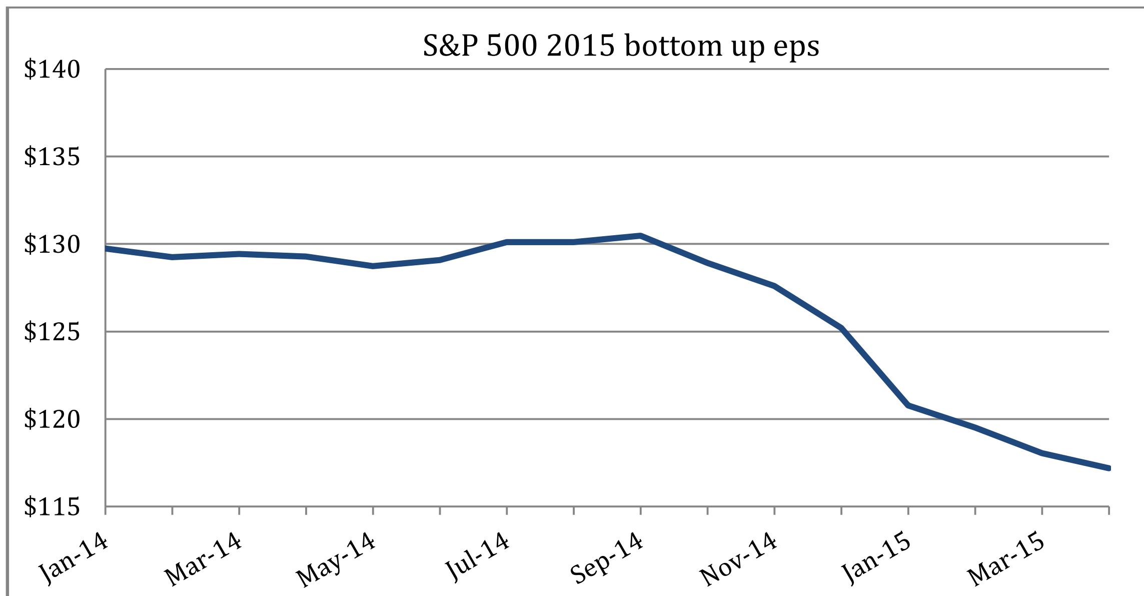
Citigroup Economic Surprise Index

First quarter Gross Domestic Product (GDP) barely budged, the weakest advance in a year. Yet once again, in this year's first four months, bad news is good news. The slowing economy suggests the Federal Reserve will drag its feet on any rate hikes. The bond market caught another tailwind, pushing 10-year Treasury yields lower one more time. Equity markets took some time to digest the data, yet still ended the first four months showing positive returns.

Investors are well-served to remember that we invest in companies, not economies. For the past six years a recurring theme has persisted in the US -- a weak economy, yet strong corporate profits. Since the 2009 bottom, nominal GDP has increased 24 percent, while corporate profits have more than doubled. Stocks have shrugged off the broad economic data, and focused on the profit line.

That makes the current earnings situation somewhat problematic.

On a continual basis, we track bottom-up analyst earnings estimates for all stocks within the S&P 500. The typical pattern is for estimates to be elevated as we enter a new year. Optimism abounds. Then reality sets in, analysts pare their numbers, and a fair measure of profitability is established. This year's reality is harsher than most, as shown below.



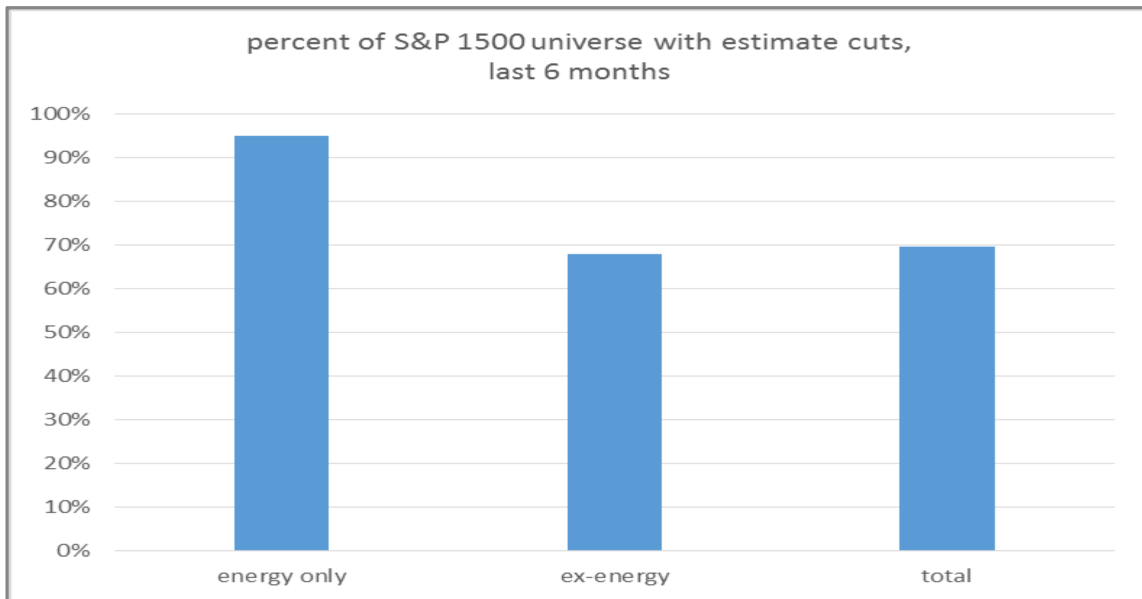
Using bottom up estimates, the forecast just months ago was for S&P 500 profits to reach 130 dollars per share in 2015, a growth rate of 10 percent. We are mighty late in the cycle to enjoy that type of earnings growth, and in fact those hopes have already been dashed.

Now we see widespread estimate cuts, with the stronger dollar and collapse in oil patch profits

serving as major contributors. Based on current estimates, S&P 500 earnings will decline for the year. Nobody was planning on this.

Economists have noted that plummeting oil prices may provide a long-term stimulus to our economy. Yet the profit drag from the energy sector is more immediate. Indeed, from a broad universe of 1500 stocks, 95 percent of all energy companies have suffered estimate cuts over the past six months. The median energy company's earnings estimate for 2015 has been slashed by 69 percent. Even the stalwart of the sector, oil giant Exxon Mobil, has seen its profit forecast cut in half.

To follow an optimistic line of thinking, corporate profits are still strong if we exclude the collapse in energy, and stock prices are reflecting the general trend. It makes sense, if only it were true. When we examine earnings ex-energy, we still see that 68 percent of companies show estimates moving in the wrong direction.



This is far and away the worst earnings performance since the end of the great recession. There is still hope for 2016, but this year's profit picture looks like a bust. Still, US stock prices are hitting record levels. With the benefit of hindsight, there is an explanation. We're just not sure how much of it to believe:

- Stocks are cheaper than bonds, even with no earnings growth this year.
- Stocks are moving higher, and investors shouldn't fight the trend.
- Easy money is still the rule at the Federal Reserve, and easy money moves markets.
- The dollar is strong, indicative of funds flowing into the US financial system.
- Investors remain skeptical, having never bought into this bull market. That's a positive.

It has happened before. Earnings do not rise in a straight line, and stocks do not always follow earnings. The critical question is whether this is a transitory blip -- a pause in earnings growth -- or a topping out. The latter would suggest stocks are fully valued, with limited upside and elevated risk. To date, the market action says it is a pause, that profits will resume their uptrend by next year.

Let's hope so.

Energy Inconveniences

The world now consumes more oil than it ever has, over 92 million barrels per day; fortunately for users, the world also produces more oil than it ever has.

The difference between global oil supply and demand equates to a one percent surplus. In most markets, this would be considered the tight side of equilibrium. Yet oil prices dropped by half in less than a year.

The proposed Keystone XL pipeline would transport crude oil 1700 miles from Canada through middle-America. Our nation's infrastructure currently includes over two million miles of pipelines carrying oil, gas, and chemicals. That means Keystone represents less than one-tenth of one-percent of our pipeline system. Why isn't anyone carping about the 99.9 percent?

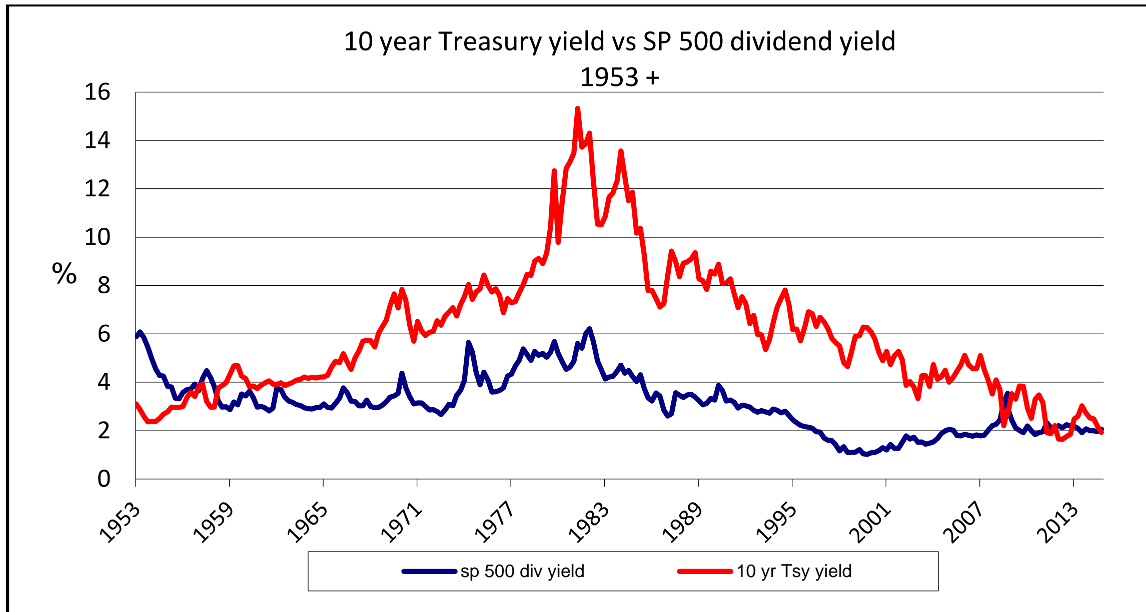
The alternative to energy pipelines is not environmentalism, it is using trains to transport oil. The big difference is that oil cargo trains travel through populated areas, and have an annoying habit of spilling oil and exploding.

Due to carbon usage and other factors, the earth either stopped warming 15 years ago, or just experienced its hottest year on record. Or both. For which one will an activist government take credit?

Based on multi-year spending plans and rounding for simplicity, America's two largest energy companies, Exxon Mobil and Chevron, each budget 100 million dollars in capital spending for exploration, production, and refining -- with no assurance of success, no control over pricing. If that makes big oil sound like a risky business, consider that those spending figures are per day.

Exxon Mobil generates a profit of eight cents for every dollar of sales, pays twice in taxes what it retains in net income, and re-invests more in capital and exploration expenditures than it earns in profits. Meanwhile, when we re-fuel our cars with gasoline, every gallon includes a federal tax of 18.4 cents and state taxes averaging 29.8 cents. That's 48.2 cents per gallon of pure government profit, with no effort. Exxon or Government -- which one is the profiteer of the energy business?

Stocks and Bonds



If we go back in time six decades and further, a market pattern existed wherein US stock dividend yields were consistently higher than yields on government bonds. The concept was simple: stocks carried more risk than bonds, so were expected to provide higher returns. Savvy investors could count on this relationship, buying stocks when the yield premium was high, and selling when the spread narrowed to near zero.

The strategy was successful, if inelegant. Then, in the late-1950s, it stopped working altogether. Rightly so. While the market behavior was undeniable, the theory was all wrong. Dividend yields are only a small portion of equity returns, with price appreciation far more important. Investors can expect a higher return from equities, without the dividend yield itself being greater than the bond yield. As financial acumen evolved, and as dividend payout ratios declined, the original concept faded into irrelevance.

So the yield spread relationship fell apart, forever. Until 2008. Since then, US stocks have sold at higher yields than US Treasurys on several occasions, and as recently as last month. The same condition exists in Europe and Japan, only by a wider margin.

This was never again supposed to happen; yet it has, this time around the globe.

An optimist might say today's yield spread proves stocks are cheap. A pessimist could claim that Treasury yields are simply too low. A realist might decide each of the two extremes is at best half right. Go with the realist.

Source:
American Petroleum Institute
Bloomberg
Exxon Mobil
Financial Times
“Stocks for the Long Run”, Fourth Edition, 2007, J. Siegel
U.S. Energy Information Administration
Wall Street Journal

Tidbits..

US bull market passes six year anniversary, among longest bull runs in history.
NASDAQ Composite sets new record, 15 years after tech bubble.
Japan's Nikkei index hits 15-year high.
Germany's DAX index reaches all-time high.
Switzerland issues 10-year debt at negative yields.
Mexico issues 100-year debt denominated in Euros.

Fine line between euphoria and insanity.

International Monetary Fund lowers global growth forecast for 2015, now expects decline in global dollar GDP.

US share repurchase activity nears record levels.
US companies set to return one trillion dollars to shareholders via dividends and repurchases.

History says managements are susceptible to "buy high, sell low" syndrome.

Procter & Gamble looking to sell or spin off beauty brands business in streamlining campaign.
General Electric, nation's seventh largest bank, to exit most of its financial service businesses.

Federal Reserve drops word 'patient' from its policy guidance, lowers rate forecast, projects shallow profile for rate hike cycle.

Markets weigh every word, display obsession with Fed-speak.

New home sales briefly exceed 500,000 units annual rate, best level since 2008.
Consumer prices decline in past year after collapse in oil prices.
Unemployment rate, at 5.5 percent, falls to seven-year low.
US household net worth reaches 83 trillion dollars, record level.

Kraft Foods to merge with privately-held Heinz, to form North America's third largest food and beverage company.
Royal Dutch Shell to pay 70 billion dollars for UK's BG Group in largest oil and gas acquisition in a decade.
Drug company Teva proposes 40 billion dollar merger with Mylan.
Comcast, facing regulators' opposition, drops plans to acquire Time Warner Cable.
US merger and acquisition valuation multiples reach highest level in 20 years.
Global merger activity rises 21 percent in past year, to seven-year high.

Large US pension plans hold more bonds than stocks, for first time in over a decade.

Smart groups make dumb decisions.

House of Representatives GOP proposes eliminating federal budget deficits in nine years.

Yeah, right.