Smith Group
ASSET MANAGEMENT

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The Earnings Recession that Wasn't

In the early days of the April/May reporting season, the topic du jour was the possibility of an impending earnings recession. At the time, we noted the median company was still expected to deliver positive growth, even if expectations for the aggregate were weaker. In addition, earnings growth was supported by fairly robust sales growth. As the season progressed, reports beat expectations at a higher rate than the previous quarter, which eliminated the expected deficit. Ultimately, 1Q19 aggregate S&P 500 earnings ended 5% higher than where they were estimated on March 31st (exhibit #1 next page), with a growth rate over the year ago quarter at about 4% (and about 5% for the median company). As a result, the earnings recession drumbeat died down. While expectations for earnings for the rest of 2019 continued to trend downward that is a typical pattern. The trajectories in exhibit #1 are fairly typical, with positive earnings surprises increasing the final results of the current quarter, and future quarter expectations slipping modestly. So, it really is no surprise that the earnings recession did not come to pass.

(Continued on page 2)

Total Return	2Q19	1 Year
Russell 1000	4.3%	10.0%
Russell 1000 Growth	4.6%	11.6%
Russell 1000 Value	3.8%	8.5%
Russell 1000 Comm. Services	4.6%	11.1%
Russell 1000 Cons Disc	5.0%	8.1%
Russell 1000 Cons Staples	3.5%	15.5%
Russell 1000 Energy	-3.6%	-14.9%
Russell 1000 Financial	7.9%	6.1%
Russell 1000 Health Care	1.6%	13.0%
Russell 1000 Industrial	4.2%	10.3%
Russell 1000 Info Technology	5.8%	15.6%
Russell 1000 Materials	5.4%	1.0%
Russell 1000 Utilities	3.4%	19.4%

Total Return	2Q19	1 Year
Russell 2000	2.1%	-3.3%
Russell 2000 Growth	2.8%	-0.5%
Russell 2000 Value	1.4%	-6.2%
Russell 2000 Comm. Services	-5.9%	7.2%
Russell 2000 Cons Disc	-0.6%	-6.7%
Russell 2000 Cons Staples	-3.2%	-11.4%
Russell 2000 Energy	-8.8%	-37.4%
Russell 2000 Financial	5.2%	-3.7%
Russell 2000 Health Care	-0.2%	-6.8%
Russell 2000 Industrial	8.6%	0.0%
Russell 2000 Info Technology	2.7%	11.5%
Russell 2000 Materials	-0.7%	-13.6%
Russell 2000 Utilities	5.2%	18.0%

Total Return	2Q19	1 Year
S&P 500	4.3%	10.4%
MSCI AC World*	3.2%	6.1%
MSCI AC World Ex U.S.*	2.1%	2.2%
MSCI World (Developed)*	3.6%	6.7%
MSCI Emerging*	0.2%	1.8%
MSCI Dev. Europe*	4.0%	4.3%
MSCI Pacific Ex Japan*	5.7%	11.0%
MSCI Japan*	-1.7%	-6.8%
MSCI China*	-4.3%	-7.0%
USD/EURO	1.4%	-2.5%
USD/Chinese Yuan	-2.3%	-3.6%
USD/MSCI EM FX	0.4%	-0.6%

* in local currency, net of tax withholding

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S&P Earnings Report Update (2Q 2019) by Chris Zogg, CFA
Market Perspectives (March 2019) by Rick Villars, CFA

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To be fair, there were sectors that did suffer actual earnings recessions. Aggregate earnings in the Energy and Materials sectors suffered steep declines from the previous year quarter, despite their median growth rate being roughly flat. Exxon's earnings dropped -50% and Chevron's -25%. Combined, these behemoths are almost 50% of the S&P 500 Energy sector, so they dominate the aggregate result. In Materials, the malaise was more widespread, and a 90% drop in Freeport-McMoran earnings exacerbated the aggregate sector result.

S&P 500 growth expectations for the rest of the year continue to be modest. Bottom-up aggregate earnings for the full year are expected to be up in the mid-single digits, but that is expected to be backend-loaded with the only quarter expected to increase in double digits being 4Q19. The median S&P 500 company is expected to increase earnings by 6.5% this year, driven by a median expected sales increase of 4%.

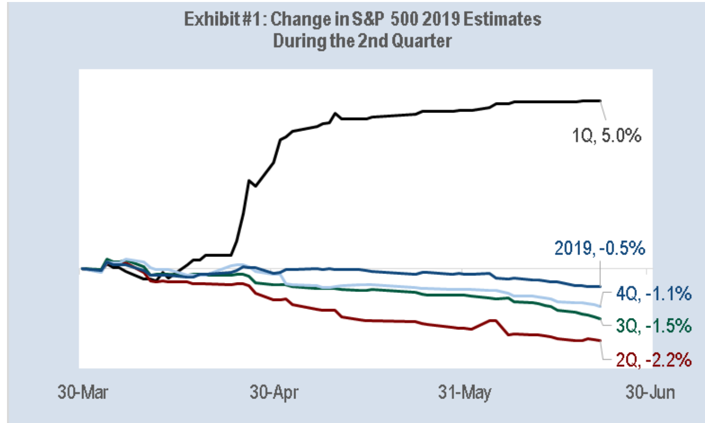

Exhibit #1: Change in S&P 500 2019 Estimates During the 2nd Quarter

Which is More Important: Saying or Doing?

Conventional wisdom is to "watch what people do, not what they say". During the April/May reporting season, that was reversed as investors' reactions to positive or negative earnings surprises were overridden by the guidance management teams gave during the conference call. Exhibit #2 gives a sense of how true that was. The median price movement for companies reporting the 20% best earnings surprises was less than half the response to receiving the best 20% of estimate revisions (a reflection of forward guidance) during the +/-3 day earnings report window. Similarly, the stocks with the 20% worst estimate revisions were punished almost twice as much as the 20% that reported the worst earnings relative to expectations. The reward or punishment for what actually happened during the quarter was dwarfed by that which was doled out for "saying" soothing, or scary, things on the conference call. Given that results in excess of expectations has historically been a good sign of future results relative to expectations, the stark contrast between rewards for doing vs. saying was quite noticeable during the quarter.

The word "tariffs" was a frequent feature in earnings call prepared remarks, as well as in the question-and-answer period that followed. While difficult to quantify, it often seemed like the more times trade tensions were mentioned, the harsher the earnings downgrade that analysts applied. There is little doubt that the uncertainty about the free flow of trade is weighing on some companies more than others. This was particularly acute in the Information Technology sector which is generally the most exposed to China. Within this group (exhibit #3), only those companies that gave positive forward guidance were rewarded (represented by the blue bar), while the rest of the sector was weighed down by trade worries.

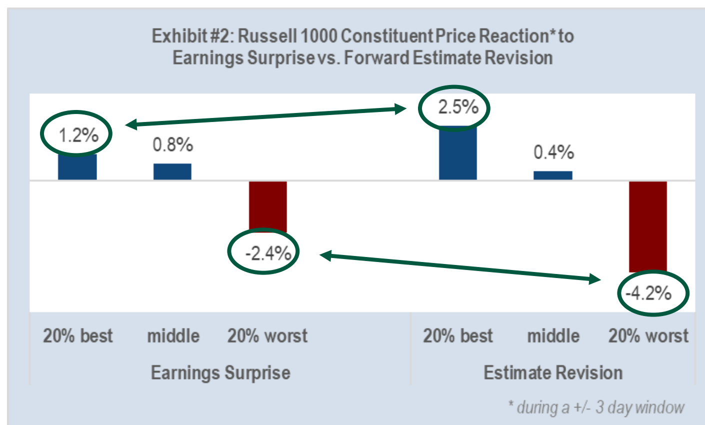

Exhibit #2: Russell 1000 Constituent Price Reaction* to Earnings Surprise vs. Forward Estimate Revision

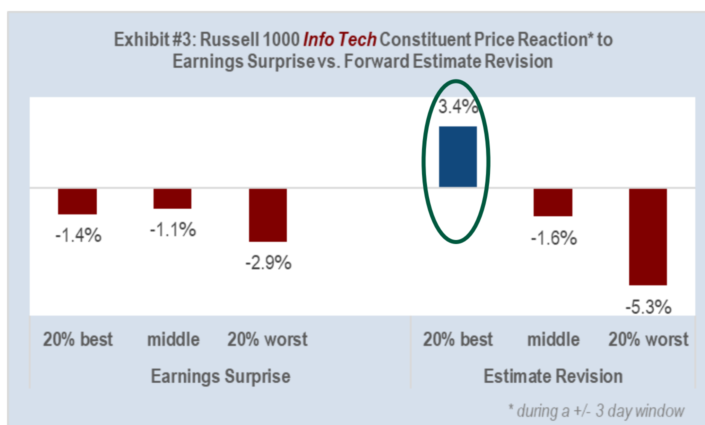

Exhibit #3: Russell 1000 *Info Tech* Constituent Price Reaction* to Earnings Surprise vs. Forward Estimate Revision

As Bad As It Gets?

With the market making new highs, it seems odd to be talking about negative sentiment, falling confidence, and deteriorating economic signals. But this is exactly what is happening.

The latest Bank of America Merrill Lynch investor survey was the most bearish since the Global Financial Crisis, and the AAII individual investor survey saw bulls drop to 22% in mid-June compared to bears at 42%. Purchasing manager surveys have fallen to around two year lows. The global manufacturing surveys have tipped into contractionary territory. Consumer confidence is off of recent highs as the current reading is close to two-year lows. But, this is still in the top 16 percentile of historical experience. There has been a marked deceleration in consumption in recent data. Domestic retail auto sales are slowing to levels last seen around the time of the financial crisis and retail sales growth is tepid. Falling interest rates have helped builder confidence and mortgage applications are firming up. But there has not been much movement in the pace of existing or new home sales yet.

Business confidence surveys, both small and large, have moderated from their highs. But they are still at relatively high levels and businesses still say they are planning to invest in capital projects (exhibit #4). However, the uptick in real private investment overall in 2017/2018 has rolled over and new orders for capital equipment are almost flat with a year ago. Businesses might recognize the need for investment, but they are hesitant to do so given the uncertainty in the midst of a trade war with China.

So, how can the market be flirting with new highs? The answer may be twofold. The first is the sideways nature of the last 18 months. New highs have been modest and failed to have much of a break out from the range. The result is that while the S&P 500 hit a new high in June, it was only 2.7% higher than the peak reached on January 26, 2018, almost one and a half years ago. Over that time period the trailing Price/Earnings ratio has fallen from 26.3x to 20.8x and the forward ratio has dropped from 18.6x to 16.8x. So the reality is that the market has traded sideways for 18 months and has gotten cheaper, which is a picture much more consistent with cautious investors.

The other aspect of the market reaching new highs in the face of negative sentiment and data is the composition of the advance. Investors have aggressively moved allocations from equity funds to bond funds. Gold and the U.S. dollar, typically risk off assets, have been rising. Small stocks are lagging the large cap advance by a margin rarely seen. Real Estate has been one of the top performing sectors year-to-date, while Utilities and Consumer Staples are in the top three quarter-to-date. This is more aligned with a cautious market than one flush with optimism. While three of the FAANG stocks are top contributors in the latest quarter, they are joined by the likes of Procter & Gamble, Coca-Cola, Walmart, and Pepsi, which are defensive names. Generally this level of caution is more of a harbinger of robust future returns than a market top.

Economic data has been so disappointing that the Citi Economic Surprise Index has dropped to a level equal to the lowest 9% of all readings (exhibit #5). But a bottom at this level may in fact be a buy signal. There have been nine such historical occurrences, excluding two double dips within a three month window. Of those, 6 times the S&P 500 was positive by at least 8% in the following six and twelve month periods. The median return over six months was 9.7%, and over twelve, it was 11.4%. While this is a small sample, it does imply that extreme disappointment is more likely to be a contrary indicator than a predictor of doom. We think of it as what happens when a stiff headwind is removed and replaced by smooth sailing. In some cases, the disappointment leads to an overly pessimistic outlook which leads to positive economic surprises.

Another contrary indicator is the U.S. Economic Policy Uncertainty Index, which has gained popularity in the last year. As the quarter ended, it spiked up to a 99th percentile reading. Once again the sample size is small, but in the 125 days following such an extreme reading, the average

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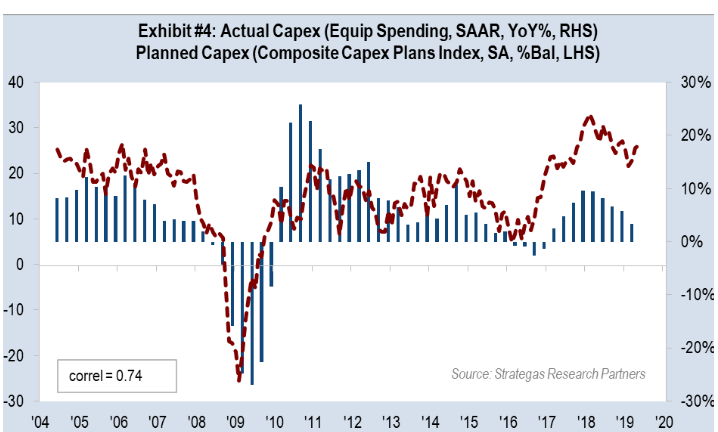


return is 8.3% and it is positive 81% of the time. In the 250 days following, the average return rises to 13.7% with a 81% positive frequency.

There are good reasons to be uncomfortable about the potential outcomes of the current global environment. Policy mistakes are a danger. But the normal criteria of a typical bear market top are mostly absent. There is no evidence of a blow-off top where investors are convinced the only direction is up. M&A and IPO activity has picked up in absolute terms, but is still quite low relative to the size of the market. The value of IPO's over the last twelve months is less than 0.2% of the value of the S&P 500 compared to previous peaks four times that reading. Real interest rates are declining instead of rising. Earnings revisions were actually positive during the latest reporting season. Finally, credit spreads are still reasonable relative to history.

If global central banks shift toward accommodation, as it appears, the market may yet find another leg up before it runs out of steam.

Rates Riding to the Rescue

June marked the ten year anniversary of the U.S. economic expansion. So the debate about whether or not it can continue is often a topic in investment forums. Trade wars not withstanding, we still subscribe to the fact that most of the time recessions are caused by an aggressively tightening Fed in their battle to control inflation. The inverted 3 month/10 year treasury yield curve is a pretty good indicator they might have gotten a bit ahead of themselves. But the steepening of the longer curves is a clear indication that they have not done irreparable damage so far. If the inflation fight can be set aside for the time being, there is plenty of room to extend further.

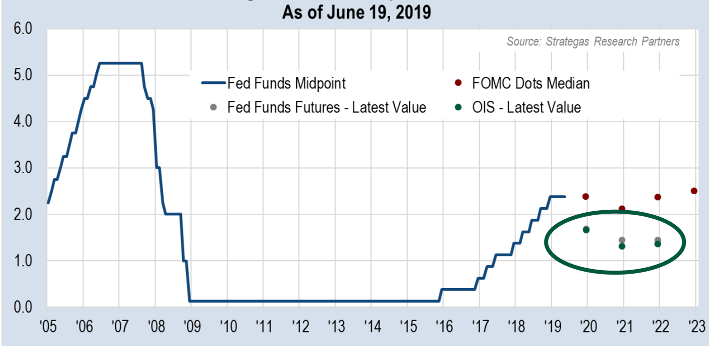
The inflation genie looks to still be in the bottle. While the tariff mechanism is short-term inflationary, in that it adds directly to the cost of an imported item, business surveys imply that these costs have not been passed on to consumers. The feeling is that consumers are unwilling to pay a higher price for discretionary goods. Wage growth, which had been marching upward toward the dangerous 4% level, has moderated a bit at the last reading. Oil is lower on a year-over-year basis and copper has been weak. The only inflation hedge that has been flashing any kind of warning is the strength in gold, but that is likely more about geopolitical tensions than inflation. Most importantly, inflation expectations have been falling.

With the slowdown being global, what other central banks do matters. The ECB "stands ready to ease", the Fed Open Market Committee is no longer "patient", the BOJ "intends to maintain the current extremely low levels of interest rates for an extended period", and the PBoC "has tremendous room to adjust policy". Twenty-five central banks have already lowered their cash rate this year, including economies like Australia, India, and New Zealand. While Brazil is not on that list, they have already cut their Selic rate from 14.25% to 6.5% over the course of 2017/18. Markets are predicting at least one Fed rate cut and maybe as many as three this year (exhibit #6). There is a strong possibility of a global central bank easing cycle developing. This gives the Fed additional breathing room to cut rates if necessary.

Global bond yields continue to be under pressure. It is remarkable that there are as many government bonds around the world yielding less than 0% today as there were three years ago when the Fed Funds rate was 0.5%. The U.S. 10-year Treasury has slipped back below 2%, last seen in 2016. Mortgage rates are a full 1% lower than a year ago and back to the levels seen in 2017. An uptick in mortgage applications is an early indicator that these lower rates could hold some stimulus.

In the meantime, U.S. economic activity is slowing, but far from in danger of tipping over. The 3.1% growth rate of the first quarter was unrevised, employment is still expanding, and consumers are still clicking the "buy now" button in the Amazon cart. There is still much that can go wrong. Notably, slower global growth, an extended trade war, or an actual military conflict. But the likelihood of a policy mistake is lessening and the economy does not have to die of old age.

Exhibit #6: Fed Target Rate Market Expectations vs. Fed Forecasts
As of June 19, 2019



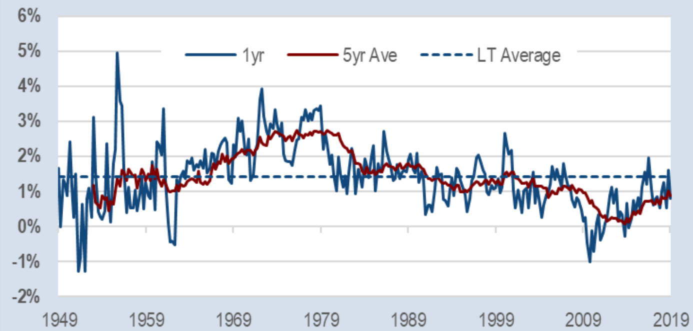
Back to the Basics of Economic Growth

Historically plentiful labor, plus plentiful resources, plus plentiful capital has been a consistent formula for superior growth. Those were the drivers of the American growth miracle. America's plentiful resources were a tailwind for much of the first two centuries of growth, but over time they became more constrained relative to the size of our economy. While the economy has evolved to be less resource driven, the oil and gas boom of the last decade is a reversal of the tightening of a critical resource and should not be discounted. The oil trade deficit has fallen by 65% from its peak. Those are dollars that we were sending overseas that can now be used for domestic investment or consumption. As domestic resources become more plentiful, the economy with continue to benefit from having less of a headwind.

In modern times, central banks around the world have made capital available since the financial crisis, but U.S. monetary growth has been subpar for the last couple of years. Yet since the beginning of 2019 there has been a modest acceleration. The U.S. financial system is in much better shape than it was earlier in this recovery and the mechanism for borrowers appears to be healthy.

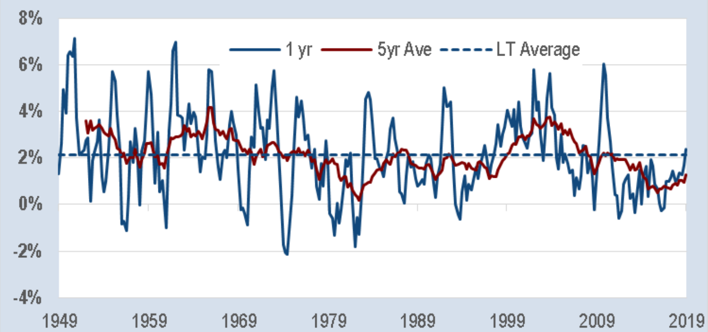
Arguably, the modern U.S. economy is more dependent on the labor component of the formula. It is not only the size of the labor force that matters; in our technology-driven environment, the productivity of that labor is equally important. Looking at exhibit #7, it is striking that the pool of active laborers has been growing at a subpar rate for most of the 2000's. The contraction was the most dramatic during the financial crisis, but the rebound has been tepid during the recovery. The current focus on protecting jobs for existing workers is likely to continue to inhibit the pool of workers available as baby boomers retire. That makes productivity growth all the more crucial. At the turn of the century the U.S. enjoyed a period of high productivity growth (exhibit #8). Some would attribute that as a dividend for investing in new technology to address Y2K issues. But the financial crisis appeared to end that benefit. Productivity has lingered below average and has been inconsistent for most of the recovery. But the last couple of years have seen a more consistent acceleration. At the latest tick, it is actually above the long-term trend. Is this the result of investment in new efficiency tools like robots that manufacture more widgets with less workers or collect packages in warehouses to fulfill the latest Amazon order? This is one of the reasons we have watched the capital investment numbers so closely. Labor-enhancing investment surely would show up in these numbers. Unfortunately, business confidence has been shaken by the uncertainty around tariffs and investment has waned a bit. It is unlikely that means they will come to a full stop from driving toward greater efficiency. With a tight labor market they hardly have a choice but to invest. But it could very well mean they make investments as needed rather than in anticipation of demand. We hope they will stay ahead of the curve and extend the rise in productivity.

Exhibit #7: U.S. Labor Force Growth



Source: FRED, BLS

Exhibit #8: U.S. Productivity* Growth



Source: FRED, BLS, *Nonfarm Real Output per Hour

We will continue to watch these numbers closely because another productivity boom like we enjoyed in the early 2000's could be a game changer for economic growth and for profits.

Disclosures

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