—New Albany—
Investment Management

June 8, 2016

Expectations are High for a (Earnings) Recovery

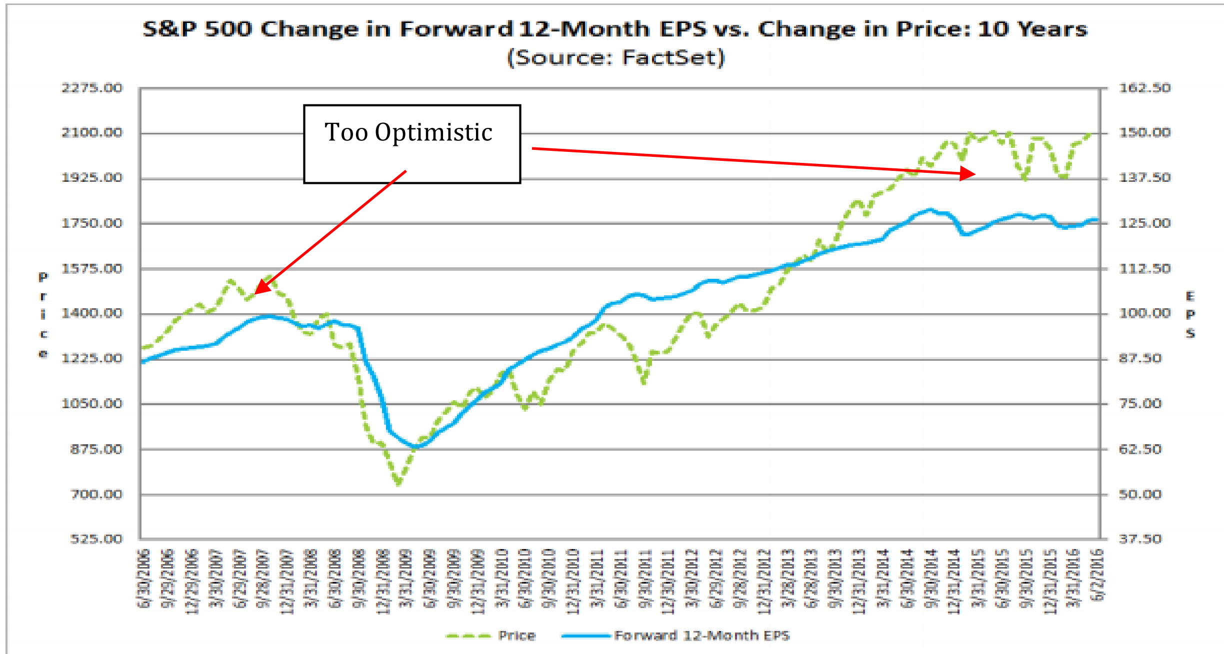
It is said that the prices of stocks today reflect what is expected six months forward. In other words, the direction of stock prices is generally viewed as a leading indicator of the direction of the economy and future earnings growth. Today, the stock market is pushing its way up to new highs this year on expectations of a recovery in the second half of this year. This action is in the face of continual subdued economic data which paints a very muddled picture of future growth. Over time, the market and the economy will come in sync, but in the meantime there is a wide span in trajectory between the two. Which is correct? Many differing opinions have been expressed from the Fed, economists and market guru's. One thing that is sure, is no one agrees. It is times like this that it is best to step back and just look at the facts. Below is a snapshot of economic data, valuation, and market action.

Mixed economic data: Last week was loaded with economic data, and gives a mixed picture of the economy. The biggest positive was construction spending for residential housing and personal consumption which increased at the strongest rate in 4yrs. However, auto sales, which have been a driving force in the rate of consumer spending over the last two years, appear to have peaked. Meanwhile the surveys of purchasing managers in both the manufacturing and services sectors imply continued weakness in business activity; and capital spending by businesses continues to decline. Finally the job report was a huge disappointment, showing hiring came to a near standstill in May. In addition, prior months hiring data was revised down, which raises serious doubts about a pickup in the rate of growth above 2%. **Minimal job growth, though not an outright contraction, supports the idea that the economy's growth is slowing but hasn't tipped over into a recession.**

Productivity falling, Labor Cost rising. These are key measures of future economic growth, inflation, and earnings growth. (Productivity is the amount of output per hour of work and labor cost is the ratio of hourly compensation to productivity.) In Q1, productivity declined -0.6% while labor cost increased +4.5%. And during this recovery, productivity growth has been unusually weak over the past five years, averaging just 0.5 percent per year, just one-third of the annual gains seen from 1970 to 1990. This explains why GDP growth has been so weak. Fed Chair Yellen said that lackluster productivity gains represented a key uncertainty facing the economy. **Falling productivity and rising labor cost are a drag on GDP and earnings.**

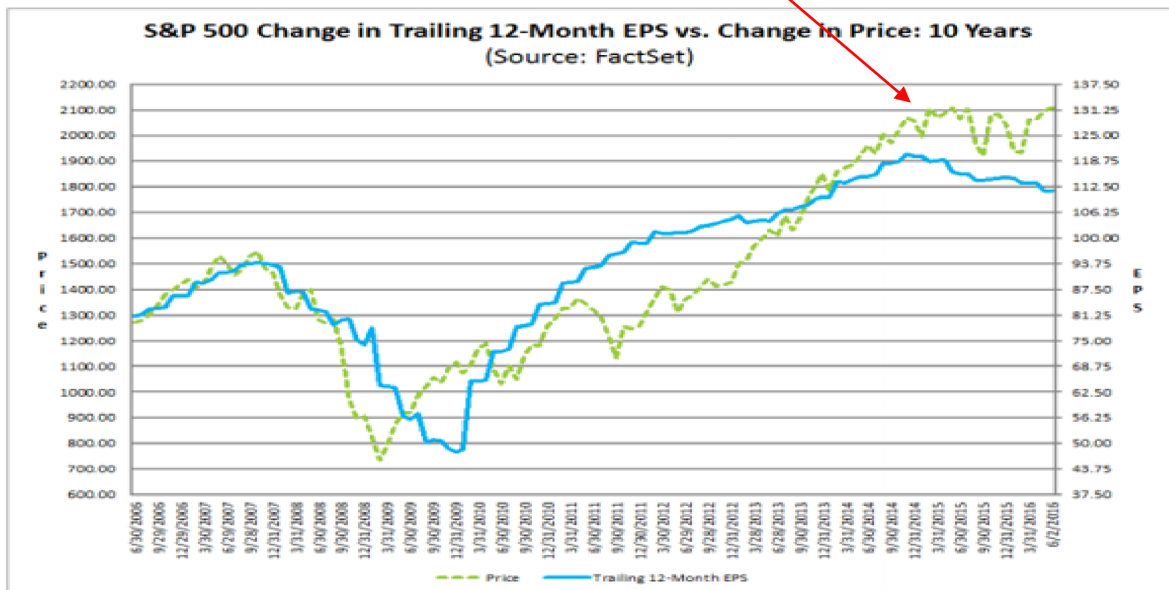
Expectations are high for an earnings recovery: For periods of time, the direction of earnings growth and stock prices may diverge, but eventually they come back into line. This divergent is where we sit today, with the stock market pushing its way up to new highs this year on expectations of an earnings recovery in the second half of this year. It has dismissed the fact that Q2 earnings are expected to decline -4.6% and if so will mark the first time we have seen five consecutive quarters of year-over-year declines in earnings since Q3 2008 through Q3 2009! Earnings growth rates for Q3 2016 and Q4 2016 are 1.4% and 7.5**%. For all of 2016, analysts are projecting earnings growth of only +0.8% and** revenues to increase slightly by +1.8% year-over-year**. Forward P/E Ratio now is 16.8, above the 10-Year Average (14.3)** The charts on the next page show this divergent and show how eventually, stock prices follow earnings.

Below is the chart of the S&P500 (green dotted line) and forecasted 12month earning growth projections of businesses (blue solid line). **Notice how the blue line is leading the green line meaning the market at times gets too optimistic (above) or too pessimistic (below) relative to forward earnings**. **Today, the market is well above the earnings forecast.** (source: Factset)

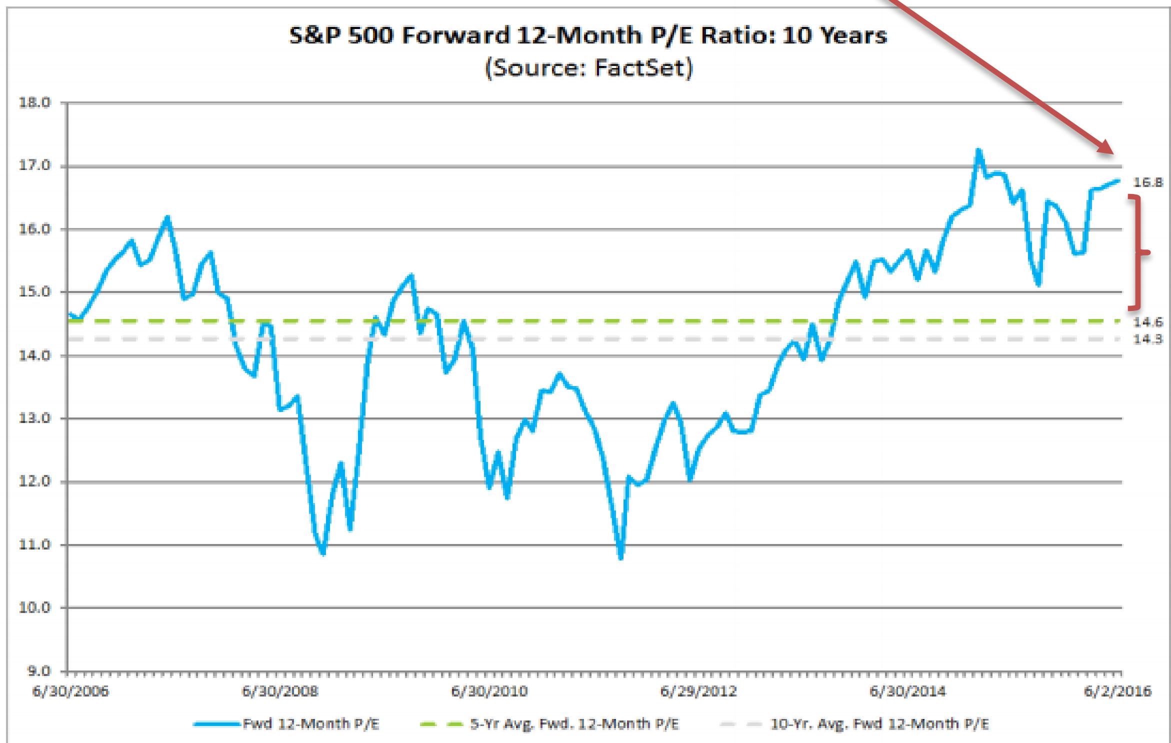


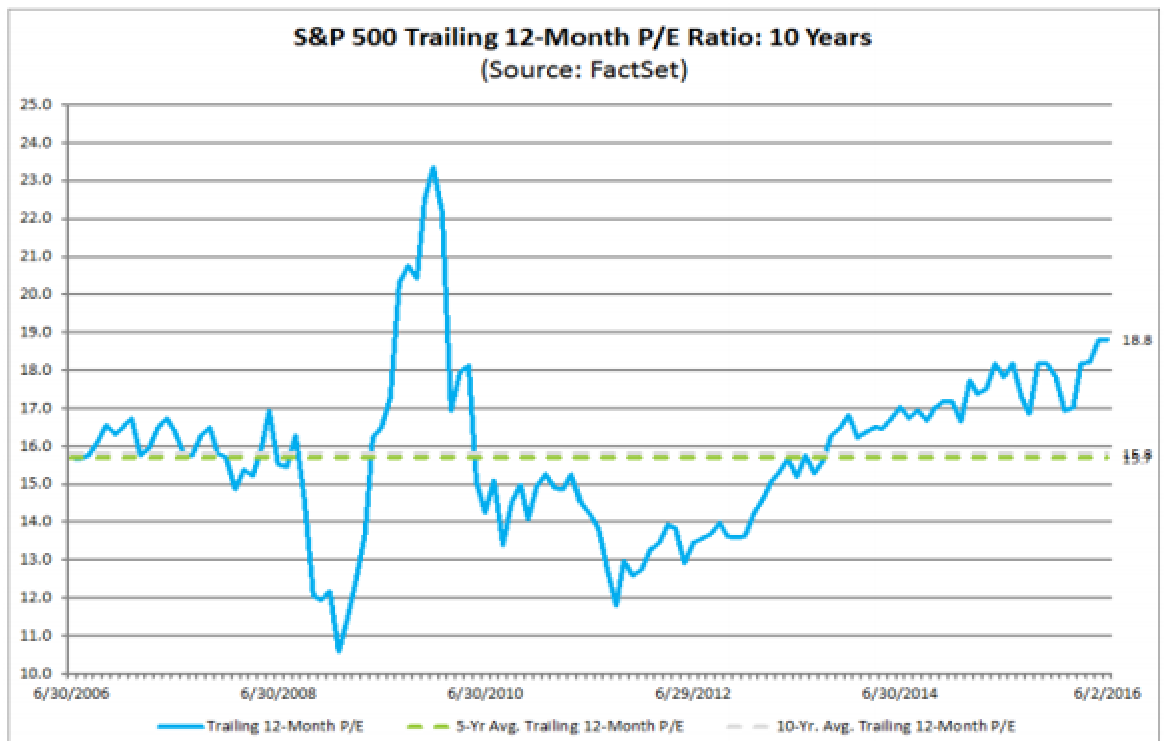
Below is the same chart but is uses **actual trailing 12month earnings**. Here it shows actual earnings have been falling (blue line) verses the market at its highs (green line).

Trailing 12M Price / Earnings Ratio: Long-Term Averages



The next two charts show the Forward and Trailing Price/Earnings ratio. In both cases the market is near its highs and over 17% above its long term average. (source: Factset)





Conflicting Market Signals: Equity Markets Bullish on future; Bond Markets signals slower growth ahead. Generally speaking, the markets are a leading indicator of the economy and usually both stocks and bonds confirm the same view. Today however, that is not the case. Despite four quarters of negative earnings growth and forecasted muted economic growth, many stock sectors are attempting to push through their previous highs. Riskier sectors such as small and mid-cap stocks are leading the charge. Meanwhile the bond market is back to near its lows in yields, highs in price, indicating investors expect no action by the Fed and a weakening economy in the months ahead. At the same time, the US dollar has weakening and gold prices are rising indicating investors expect rates to eventually fall even further (perhaps into negative territory).

Forecast by Businesses remain muted: Business economists are giving a more pessimistic outlook about U.S. economic growth this year for the third consecutive month and uncertainty over the November presidential election is inhibiting plans for spending. The median estimate from economists surveyed by the National Association for Business Economics calls for gross domestic product growth of only 1.8 percent, down from the 2.2 percent annual forecast in March. The outlook for next year calls for 2.3 percent growth. The survey released Monday also shows the forecast for growth in corporate profits swinging from a 2 percent gain in March, to negative 2 percent in June.

In sum, the current environment has positive expectations but negative data. The market appears out of sync with the data, but it is a leading indicator. So it is a wait and see game and means the next several months (maybe even through the election), the market will likely remain volatile until more clarity is evident.

Investment Strategy: Slow but Sure. Despite the muddled outlook, there is still opportunity to make money. Maintaining a lower risk profile with broad diversification to stable areas of the economy is key. Specifically, for stocks the portfolios have Consumer Staples and Dividend paying sectors and in the bond space, the portfolios have short term high yield and medium term corporates.

As always, please contact me with any questions or concerns.

I hope you are enjoying the summer bliss!

Kind Regards,

Barbara

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