Weekly Update: Horror is a relative term, I guess

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This week I traveled in and around Sacramento, Calif., where it was hot! What?? Allergy problems again!! Yes, I was told, as Sacramento boasts the second most trees per capita in the world, behind Paris, earning it the name City of Trees. Meeting only with advisers, they were relaxed and agreeable to my arguments. But I heard some horror stories about clients. One told me, “It’s the end of the world—I hear that all the time. Yet they don’t know what they are worried about.” All the worrying reminds us the pain bid in equities remains very much in place, with near-term performance considerations forcing fundamentally focused investors to reluctantly chase returns (their own kind of horror). If anything, the pain is growing more intense as the S&P 500 crosses 2,100 and the calendar moves into April’s final week. The Q1 earnings season has barely begun yet macro perspective investors already are moving on—enough large companies have posted better-than-feared numbers to consider the overall season to be positive even though the majority of results are still to come. The pre-announcement period was one for the ages, with consensus operating earnings-per-share (EPS) growth falling from +11.7% at year-end 2015 to -0.2%. The 4-week change in the current estimate is -10.6%, *the biggest decline since April 2009*, when the S&P was in the early stages of its biggest 6-month rally since the Great Depression. Just 1½ years earlier, when the 10%+ downward revision threshold also was crossed on 12/21/2007, the S&P had *just begun* its steep 2007-09 sell-off. Looking at the past 10 cases when 4-week EPS revisions first fell below -10%, Ned Davis Research says S&P performance 26 weeks later was up 5 times and down 5 times, with a median change of -0.6%. All but one of the cases were within 6 months of a recession, the exception being 10/13/1995, when the market gained 8.9%. All that said, whether using the current $120 2016 EPS consensus or even $123, valuations are stretched and are undergirding the pain trade.

Conventional wisdom has it that a surfeit of central bank liquidity and management’s ability to use it to manipulate earnings have driven earnings improvement. But Strategas Research says from both a notional dollar and per-share basis, share buybacks appear to have had little to do with it. Lower interest expense and the ability of corporations to keep labor costs under control has had a much bigger impact, and any hint of stronger top-line growth could result in even greater bottom-line gains. The 1.6% decline in S&P sales over the past 12 months includes a 29% plunge from energy alone. Ex-energy, sales were up 2.1%. As a result, margins shrank almost exclusively because of energy, which suggests margins—and earnings—should improve if the firming in crude oil prices holds. The latest Energy Information Agency production report supports the case a bottom has been made, and the news out of Doha last weekend was essentially neutral despite initial worrisome headlines. Moreover, dollar momentum has slowed; the 12-month change is below 0% for the first time since July 2014. Historically when the dollar turns negative year-over-year (y/y), S&P EPS has climbed at an 11.1% annual rate. Stabilizing oil and a moderating if not weakening dollar eliminate 2 headwinds to earnings, though neither is assured and multiples remain a mystery. In an era of financial repression in which central banks purposefully manipulate the risk-free rate, it’s difficult to determine the proper multiple for stocks. When one considers inflation, inflationary expectations and long-term rates, it’s hard to claim that equities are excessively valued. On the other hand, a weaker dollar tends to temper multiples, as investors do not reward companies for currency-induced gains.

While valuation remains an obstacle, the NYSE advance/decline line has been making a series of new record highs, which is bullish, and many historical and breadth indicators are positive. Dudack Research also notes that, looking at 7 long economic cycles from April 1960 to March 2001, there tends to be an earnings decline or flattening in growth roughly 7 years following a major earnings peak. The average slump lasted 18 months, which equates to 101 months past the original peak. When overlaying the current earnings cycle vs. history, 2015's earnings recession had remarkably similar timing to the average earnings cycle slump. If this parallel were to continue, history suggests there should be a pickup in S&P earnings growth directly ahead in 2016-2017. Then again, we’re just a few weeks away from entering the historically unimpressive summer seasonal period, and seasonality tends to peak in June during election years. This summer could see added volatility with July’s Republican convention, where despite Trump’s strong performance in New York this week, it’s uncertain if he’ll arrive in Cleveland with enough delegates to prevent a brokered convention. Washington Analysis says Trump needs to win big in California to make the delegate math work. And California’s June 7 primary is one of the last of the season. Strap yourselves in! I very much enjoyed meeting with the advisers. My favorite question: “In your travels, does anyone ever disagree with you?” Hmm. Can’t remember when…

Positives

This makes it hard to envision recession anytime soon Initial jobless claims unexpectedly fell to 247K in the week ending April 16—the survey week for the Labor Department's April employment report. No special factors were cited for the drop-off. The decline put initial claims at their *lowest level since 1973,* and relative to employment, to *a record low.* Continuing claims dipped to their lowest since 2000. Both send a powerful message of U.S. labor market strength.

More good than bad in housing numbers Existing sales rebounded in March, nearly reversing February's decline and lifting the 12-month average to its highest level since October 2007. Single-family sales led the increase, and the median price rose, as also was the case in the FHFA gauge. Starts and permits fell, though the data tends to be choppy and subject to seasonal quirks. On a 12-month basis, starts were still up 14.2% and permits were up 4.6%. Builder sentiment was unchanged at 58, subdued relative to last October's cycle high of 65 but consistent with a slow but steady pace of recovery in the single-family housing sector. The 6-month outlook for both sales and buyer traffic ticked up. All in all, the reports were reflective of positive momentum in housing.

Consumers have a lot of powder Over the past 7 years, consumer net worth has increased 60%, or $34 trillion—twice the size of the U.S. economy. A lot of this has to do with the risk markets, but rising house prices are playing a role, too. The median price reached $230K in March, Evercore ISI says, exceeding its 2005 peak of $229.9K. This is good for consumer confidence, lifts consumer net worth and pushes fence-sitters to move into the market.

Negatives

Not so fast calling the 'All Clear' for manufacturing After jumping in March, the Philly Fed index unexpectedly reversed in April, contracting again as new orders fell sharply and shipments declined to their weakest reading since late 2012. The labor market side of the survey was weak as well, with the average workweek and employment components significantly contracting. The decline contrasts with last week's improvement in the Empire survey and is notable as the Philly gauge tends to act as a bellwether for national trends, where the latest ISM index had suggested improvement. Markit's flash reading on April manufacturing this morning also softened to its lowest level since September 2009.

Leading indicators disappoint They rose by half the expected increase in March, hurt by the decline in housing permits, softness in manufacturing and less accommodative financial conditions. Still, the index is up 2.2% y/y, indicating slow but positive economic growth.

China Watch Last week we were encouraged by signs of stabilization in China; this week we're reminded a worrisome credit bubble may be underpinning the improvement. China's social financing rose $1 trillion in Q1, the fastest 3-month increase in a series dating to 2002. Bank loans drove the surge and total over $15 trillion, tripling in yuan terms since January 2009. The ratio of bank loans to industrial production has jumped to 160 from 100, where it hovered from 2000-2008. China seems to be getting less and less bang per yuan, i.e., it's taking more and more credit to keep it growing at a slower and slower pace. As Larry Summers pointed out in January, "China put in place more cement and concrete between 2011 and 2013 than the United States did in the whole of the 20th century"—a level of construction suggesting the goal was boosting current activity, not making sound investments. Its mounting excess capacity in a slowing global economy is raising the risks of protectionism, a major issue the U.S. presidential campaign, and of painful consequences when credit slows.

What else

Political Watch Obama's visit to London is partly being done to voice support for the U.K. remaining in the EU. But what would happen if Angela Merkel or any other European leader made a trip to Washington or New York and opined on a U.S. election? To some extent, this already has happened, with Obama and Secretary of State Kerry revealing they are receiving worrisome comments from foreign leaders about the tone and substance of what Republicans are saying as they campaign for president. This will blow back in the Republican's favor, the Institutional Strategist says, as the people supporting Trump and Cruz see foreign governments such as China and even Mexico as a source of their problems rather than a partner to be worked with. They couldn't care less about what Beijing or Mexico City think … Hillary Clinton's extremely poor and sinking favorability ratings in the latest polls—42% of the country has an unfavorable view of her, more than 3 times the share that has a favorable view—have her only beating Cruz 46%-44%, although her standing with the public is far better than Trump's. This suggests Clinton would defeat Trump but a contest with Cruz would be competitive.

Political Watch "Look, nobody has better toys than I do. I can put them in the best planes and bring them to the best resorts anywhere in the world." – Trump, explaining to the New York Times how he could bribe delegates if he wanted to in order to win their support in a brokered convention.

There are horror stories and there are horror stories I met a millennial in California who informed me about the changing face of dating. “Now everyone is using online dating services, there are so many of them,” he said. “I have heard horror stories …” (Oh, I hope he doesn’t tell me about poor young ladies meeting her demise, but instead,), “of women running up the bill at a restaurant.” I love the millennials!!

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S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

The Conference Board's Composite Index of Leading Economic Indicators is used to predict the direction of the economy's movements in the months to come.

The Empire State Manufacturing Index gauges the level of activity and expectations for the future among manufacturers in New York.

The Federal Housing Finance Agency's (FHFA) seasonally adjusted purchase-only price index is a gauge of prices of existing homes.

The Federal Reserve Bank of Philadelphia gauges the level of activity and expectations for the future among manufacturers in the Greater Philadelphia region every month.

The Institute of Supply Management (ISM) manufacturing index is a composite, forward-looking derived from a monthly survey of U.S. businesses.

The Markit PMI is a gauge of manufacturing activity in a country.

The National Association of Home Builders/Wells Fargo Housing Market Index is a gauge of how well or poorly builders believe their business will do in coming months.

The New York Stock Exchange (NYSE) advance/decline line measures the ratio of advancing stocks to declining stocks.

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