Third Quarter 2017 Outlook and Commentary

The KISS principle--Keep it simple, stupid—admonishes engineers to avoid unnecessarily complex designs. It's also pretty good advice for anyone trying to explain the ups and downs of the stock market. In that spirit, there is a simple explanation for the U.S. stock market continuing to achieve record highs. Share prices are tightly linked to corporate profits, and bottom lines happen to be booming. For the twelve months ended March 31st of this year, S&P 500 earnings jumped 16.0%. For the quarter just ended, the corresponding number may come in at a whopping 22%[1].

The recent spike follows nearly two years of deteriorating earnings as a result of a deep recession in the energy sector that began in late 2014. Plunging oil prices had a bruising impact on oil exploration, development and production, and the pain quickly spread to drilling equipment manufacturers and other suppliers. Around the same time that oil prices were sliding the dollar was soaring, dealing a blow to U.S. based exporters and further denting corporate earnings.

Second quarter earnings reports have only just begun to come in, so the latest hard data is from the first quarter. Using March 31st results, the trailing twelve month price-to-earnings ratio (p/e) of the S&P 500 stands at a lofty 24.5 as of this writing. Using second quarter estimates, the p/e is still elevated but slightly less scary at 23.1. Analysts expect earnings to climb an additional twenty percent or so over the next eighteen months. In a best case scenario, share prices would rise but by less than twenty percent, allowing the p/e to settle in to a more sustainable (but still elevated) level.

How realistic though is it to think that earnings will continue to climb so rapidly? As the chart on the next page (courtesy of Ed Yardeni's website) illustrates, corporate profitability (earnings as a percentage of revenues) is already in nosebleed territory. Operating margins (the blue line), which adjust for one-time events, are just shy of all-time highs and will almost certainly surpass them when second quarter earnings are tallied[2]. Reported margins (the red line), which aren't subject to any adjustments and are therefore a bit more volatile, are still a bit short of the early 2015 peak but appear likely to achieve a new record this fall.

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[1] The percentage growth cited reflects earnings over the prior twelve months in relation to the same figure from one year earlier. As is our custom, these are "reported earnings," which unlike "operating earnings" are not subject to manipulation.

[2] The chart only goes back to the early 1990s, but data going back to the late 1940s would show the same thing.

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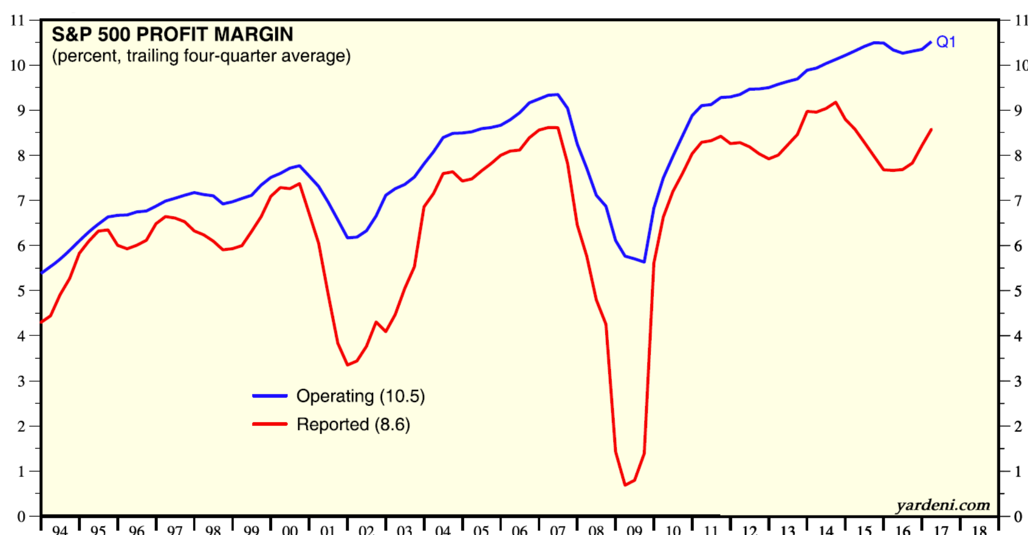

Source: Standard & Poor's Corporation (revenues and reported EPS) and Thomson Reuters I/B/E/S (operating **EPS**).

All of this suggests an unsettling possibility. Could profit margins pull back over the next several years to something closer to the historical average of around 6%? If they did, corporate earnings would decline and the stock market would be in for very rough sledding. Fortunately, there is reason to doubt profit margins will revert to earlier levels. To a much greater extent than ever before the U.S. economy (and the U.S. stock market) is based on intellectual property (IP). Back in the heyday of U.S. manufacturing, mid-single digit margins were the norm. Today, companies like Facebook or Alphabet can report 20% margins and apologize to investors for having a bad quarter. And the transition from an industrial economy to an IP-based economy goes beyond the tech sector. Companies ranging from Coca-Cola to Johnson & Johnson to 3M rely much more on trade secrets and the value of their brand than their ability to build things. Across the board, large U.S. listed companies enhance shareholder returns through global supply chains in which low-margin manufacturing is outsourced to suppliers based in developing markets. Even if profit margins aren't poised for a big decline, however, it's sobering to recognize that current stock market valuations rely on earnings that look high by historical standards **and** p/e multiples that are lofty as well.

If earnings are to grow fast enough to justify stock market valuations, the global economy will have to do its part. In the U.S. at least, the news on that front over the last few months has been less than stellar. The Citigroup Economic Surprise Index monitors U.S. economic data and how it compares to expectations. When the index is high, data is surprising on the upside; when it's low, data is surprising on the downside. The index recorded a six-year low in June as indicators ranging from auto sales to housing starts to business loans to wage growth weakened. The one bright spot has been the labor market as the economy continues to generate north of 150,000 jobs a month. At that pace the unemployment rate should continue to fall, and, one would expect, wage growth would accelerate. In fact, it's a bit of a mystery why wages aren't climbing more rapidly. Subdued employee costs are contributing to those elevated profit margins, but in the long run companies and workers alike would probably be better off if compensation growth picked up. The wage mystery aside, robust job growth suggests that the economic expansion will continue for the foreseeable future even if the idea of sustained GDP growth above two percent is as elusive as ever.

The picture looks somewhat mixed outside the U.S. as well. On the plus side, the European economy continues to strengthen. Exports--especially in Germany--are strong, and consumer spending and business investment are riding a wave of increasing confidence. Over the last few months voters in the Netherlands, France and Italy rejected anti-European Union parties, and that is lifting spirits. While two percent GDP growth is considered so-so in the U.S., in Europe, where the labor force is flat, perhaps even shrinking, two percent would be cause for celebration. It's not much of a stretch to think that full year 2017 GDP growth may just get there[3].

China, which was a bright spot in late 2016 and early this year, is a bit of a question mark. In April, at the behest of President Xi, policymakers launched a "regulatory windstorm" aimed at decreasing leverage and curbing the excesses of the "shadow banking system." So far, strong export growth has buffered the impact of policy tightening, and a lull in the crackdown over the last few weeks has raised questions about the whether the government will see it through. Still, it looks like there's a lot more downside than upside in the second half of the year.

Outside of China, the emerging markets outlook varies from country to country. As a group they appear to have turned a corner, as regions that were crushed by plunging oil prices and a strong U.S. dollar, have generally stabilized. Heading into 2017 emerging market stocks had one big advantage, which was valuation. P/E ratios at that point were about 1/3 below U.S. levels, and that's a big reason the MSCI Emerging Markets Index returned a blistering 18.6% in the first half. More broadly, foreign developed markets (as measured by the MSCI EAFE Index) returned 14.2%. After seven years of nearly uninterrupted underperformance, is 2017 the year that foreign stocks finally outperform U.S. stocks?

In its favor the U.S. stock market has a disproportionate share of dominant global brands, especially in technology where the so-called FAAMG stocks (Facebook, Apple, Amazon, Microsoft and Google) continue to dominate our digital lives[4]. While that advantage is hard to argue, it's another question altogether whether it's enough to justify valuations that are based on historically high p/e multiples applied to near-record profit margins. We're pretty skeptical on that score, and if corporate earnings growth slows down in the second half of the year, that skepticism could become more widespread.

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[3] How well are things going in Europe? Greece appears poised to return to the bond market. Think about that for a moment: after umpteen different bailouts, some investment bank is prepared to lend money to the Greek government!!!

[4] But keep an eye on the Chinese BAT stocks (Baidu, Alibaba and Tencent), which are as dominant in China as FAAMG is elsewhere. As China's influence grows, the presence of BAT outside of China will likely increase.

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