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Earnings to Economy: "No Recession"

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One company at a time, the forward consensus isn't worried about the latest crisis *du jour.*

Update to strategic view

US STOCKS: Forward earnings growth has been the rising floor gradually dragging stocks higher. Undeterred by recession fears, forward earnings are growing again at double-digit rates, and should support stocks even as they flirt with new highs.

[see Investment Strategy Dashboard]

Several weeks ago, before second quarter earnings season kicked off, the conventional wisdom assumed the worst -- as it has every earnings season for the last several years. Once again, an economy that is far stronger than officially reported or generally understood has produced an upside surprise, and the S&P 500 has moved to new cycle highs. A little more than a month ago, at the worst of the panic about subprime lending and the demise of the yen carry trade (see "Subprime Time" February 26, 2007 and "Carried Away" March 1, 2007), the annualized rate of earnings estimate revision had slowed to zero. Now 12-month forward estimates have been revised upward 13.1%, on an annualized basis, compared to one month ago. So at least for the moment, it's not out of the question for the S&P 500 to deliver a fourth year in a row of double-digit earnings growth, despite the widespread conventional wisdom that the economy is sharply slowing.

The earnings consensus is not formed by macroeconomists' or market strategists' opinions about the housing bust, the subprime meltdown, inflation, the Fed, the yen carry trade, or overheating in China. Any possible spillover from those alleged crises into the economy at large is assessed at the grass roots, one company at a time, by thousands of separate analysts. Aggregated into a cap-weighted consensus, we get a refreshingly macroeconomics-free take on the macroeconomy. Historically, whenever the earnings consensus has turned negative, a recession follows one year later (see "The Out-of-Consensus Consensus"

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June 26, 2006) -- and whenever there has been a recession, the consensus had turned negative one year before. The rapid ramp-up of earnings estimates over the last month suggests that recession fears right now are completely misplaced.

It's true that, even at today's high levels, earnings growth rates have fallen from the stellar levels of three years ago when the present expansion was still recovering from a low recessionary base. But for the S&P 500 other than the energy sector, today's growth rates are actually very much like those that have obtained for the last two years. From mid-2004 through 2005, soaring energy earnings revisions contributed disproportionately to S&P 500 earnings growth. As energy sector revisions fell dramatically starting in early 2006, overall S&P 500 earnings were dragged lower, much as overall real GDP growth was dragged lower in 2006 by negative growth in the housing sector. But just as growth troubles in housing haven't spilled over into the rest of the economy, earnings troubles in energy haven't spilled over into the rest of the S&P 500.

Energy sector earnings are rapidly stabilizing now, with earnings revisions now running about flat after falling at a 10% annualized month-over-month rate a month ago. At the same time, the sector currently experiencing the most dramatic upward revisions is basic materials, up almost 100% on an annualized basis compared to one month ago. With these moves in forward earnings in the two most inflation-sensitive sectors, the forward consensus is signaling the end of the February/March recession panic -- but it is also signaling a reacceleration of inflation risk.

BOTTOM LINE: Since the bottom of March 11 2003, stocks prices have risen only 10% more than forward earnings. Put another way, with stocks near all-time highs, the S&P 500 forward price/earnings ratio has only expanded to 15.3 from 14.4 at that panic bottom four years ago. With so little fat in equity valuations, forward earnings growth is a rising floor under stock prices, and should continue to gradually drag prices higher much as it has over the last year.