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MACROCOSM

Earnings to the Rescue

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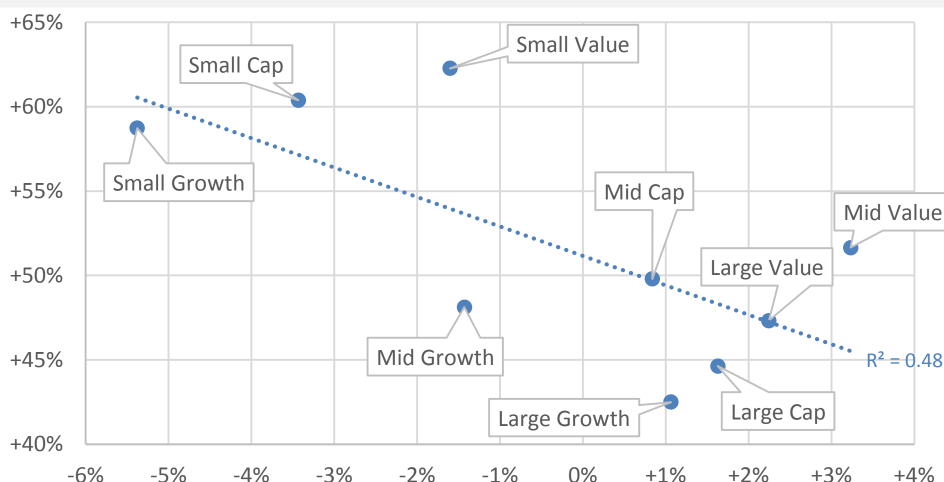
Donald Luskin

Amidst disappointing 2014 equity returns, we're seeing the best upgrade rate in years.

In conversations with clients, we detect a bit of a malaise, tinged with an element of apprehension. There seems to be a widespread sense of disappointment that stocks haven't performed better in 2014 -- and a concern that this may signal trouble ahead. *We're by no means as discouraged, and see much in recent earnings developments to support a much more optimistic outlook.*

- On the face of it, there's nothing alarming about the 2.7% total return year-to-date for the S&P 500. At an annual rate of 6.7%, that's not a giant shortfall from the long-term average of 10.1% -- which is about what most clients told us they were expecting last year-end. We expected better then (see "2013: The Year of Living Not Dangerously" December 31, 2013) -- and we still do.
- Is a little rest so disappointing after a total return of 53.1% over just 19 months, from the bottom of the last true correction for US stocks, which ended on June 1, 2012?
- The underperformance year-to-date by smaller-cap and growthier stocks (see "Growth: Over Valued and Under Attack" April 9, 2014) falls into line perfectly with this view. Size and style sector

YTD performance (horizontal axis) versus performance from June 1, 2012 correction bottom (vertical axis) Price-only return



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS: Clients are telling us they are disappointed and worried by lackluster US stocks returns so far in 2014. Returns are not, in fact, very far below average -- and remarkable after a 53% run in the prior 19 months from the June 2012 correction, and the ominous news backdrop. Worse returns for smaller and growthier stocks in 2014 correspond to their better returns in the prior bull run. This earnings season has been the best upside surprise in three years, with the lowering of expectations during Q1 being only a sensible seasonal adjustment. The strong net beat was distributed across the S&P 500, not concentrated as usual in just the top ten companies. Most important, the forward earnings upgrade rate is surging to its highest level in years. We stand by our expectations for double-digit returns this year for US stocks.

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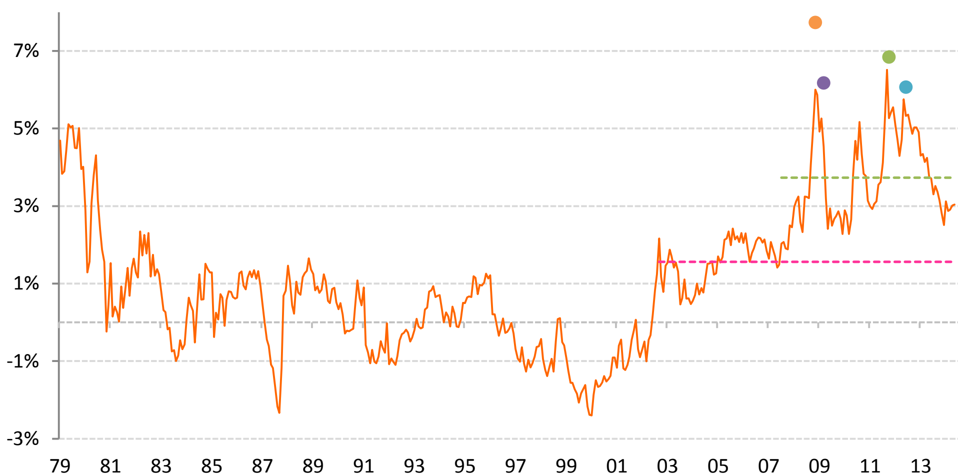
performance in 2014 is strongly inversely correlated to performance over the prior 19 months (please see the chart on the previous page).

- *It's actually a sign of strength that US stocks have performed as well as they have, given a news backdrop including virtually the harshest January/February weather in the history of the data* (see "On Q1 GDP" April 30, 2014)*, the Fed's tapering Large-Scale Asset Purchases* (see "Bernanke's Last Big Call" January 21, 2014)*, the inauspicious debut of a new Fed chair* (see "On Yellen's First Public Speech as Fed Chair" March 31, 2014)*, the annexation of Crimea and continued unrest in Ukraine* (see "Client Conference Call: Former US Ambassador to Ukraine Steven Pifer" May 2, 2014)*, and fears of a slowdown in China. For all that, stocks have only have had to endure a mere 6.1% correction this year from mid-January to early February -- out of which they rallied 9.2% to new all-time highs, from which they are now only off 1.6%.*
- The stalwart performance by stocks in 2014 is all the more remarkable considering that they came into the new year with an equity risk premium near the bottom of the crisis-era range (please see the chart below). So by the standards of the last six or seven difficult years, stocks were expensive.

S&P 500 equity risk premium (forward earnings yield minus 30-yr Treasury)
Crisis-era mean **Pre-crisis mean**



Source: Bloomberg, TrendMacro calculations

The surprisingly durable performance of seemingly richly valued stocks against a seemingly bleak news backdrop confirms for us our view that we are in the process of transitioning to a less risky and more growth-friendly world -- one more like that of the mid-2000's (see "A Major Upgrade to our Strategic Outlook" September 12, 2013). If that view is correct, the equity risk premium is likely to fall to pre-crisis levels (please see the chart above), in which case stocks are not richly valued at all (see "Regime Change for Equities" November 26, 2013) -- indeed, they are undervalued.

We are encouraged in this view by the evolution of the present earnings season. Pessimism about Q1 earnings was demonstrably overdone, and

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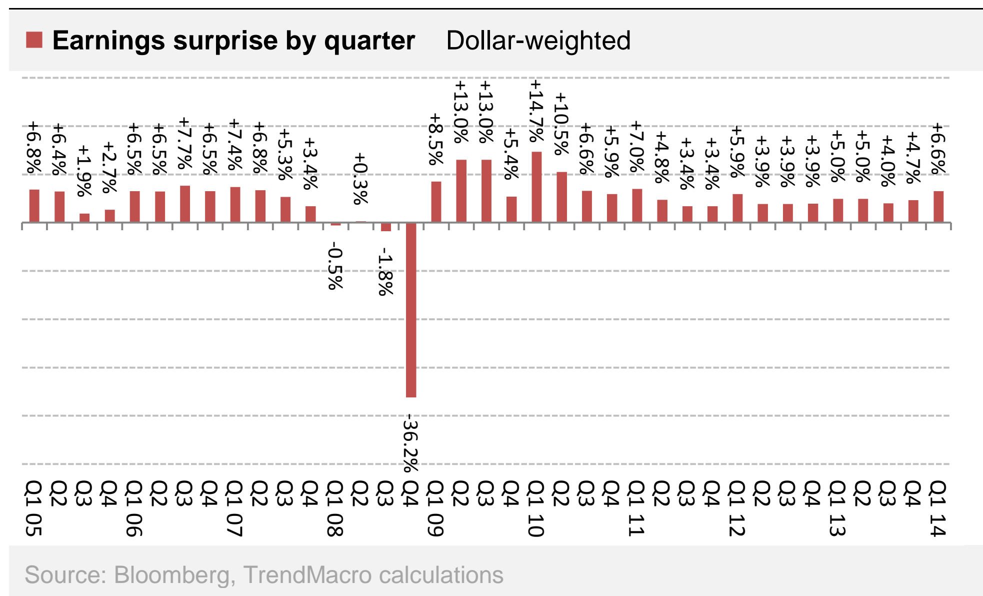
optimism for the rest of the year is now emerging.

- The dollar-weighted earnings surprise factor this season has been the best in three years (please see the chart below).

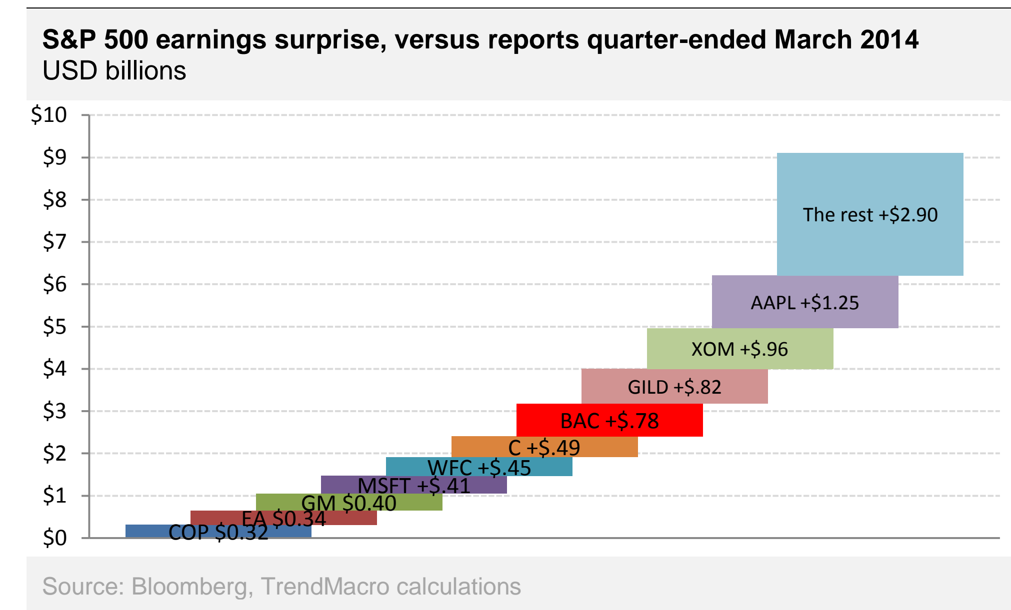
Earnings surprise by quarter Dollar-weighted



Source: Bloomberg, TrendMacro calculations

- Yes, estimates for the quarter ended March were lowered sharply, by about 5.2% from-year end across the S&P 500. But that is almost always true to some extent (for example, in the prior two quarters estimates were reduced by 1.3% and 2.6%, respectively). Q1's unusually large reduction was a sensible "seasonal adjustment" as the coldest winter since 1985 revealed itself. And despite the winter, reported earnings came in 1.4% higher than what was expected before anyone knew how bad it would be, before estimates could be lowered.
- This earnings season's surprises were quite well-balanced across the 428 companies reporting quarters ended March (please see the chart below). For the past several years, the net beat has been

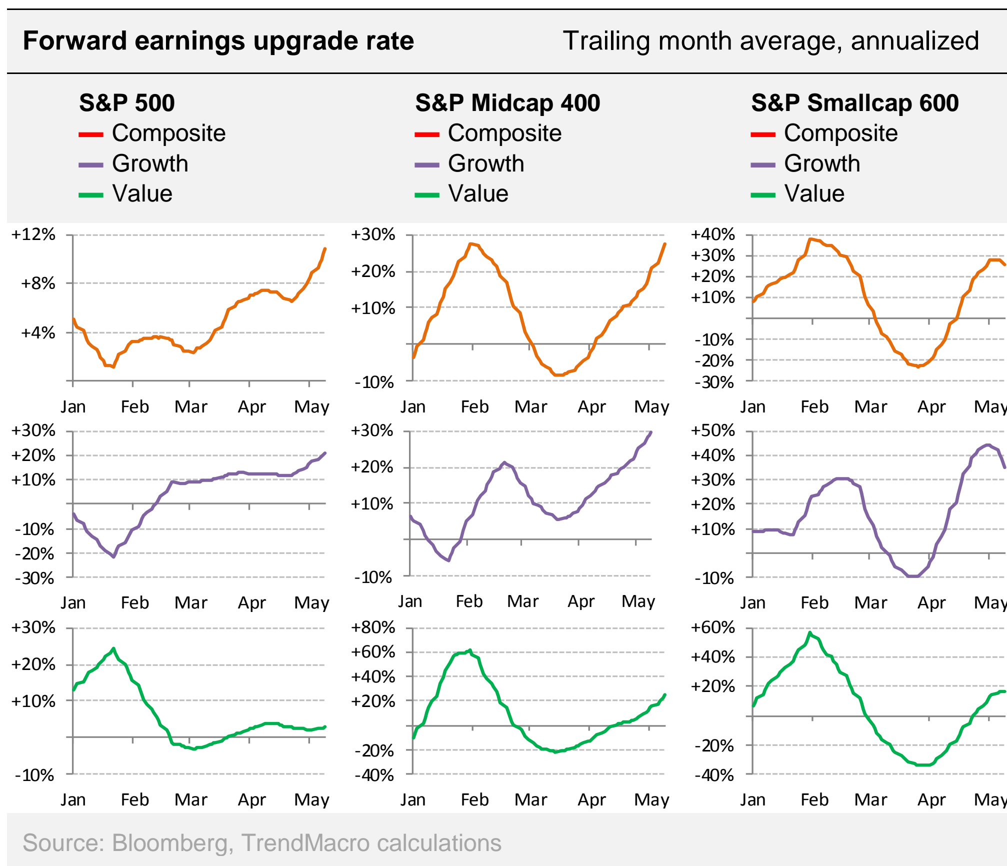
S&P 500 earnings surprise, versus reports quarter-ended March 2014
USD billions



Source: Bloomberg, TrendMacro calculations

concentrated entirely in the top ten biggest upside surprises -- usually banks and big tech firms -- with the remaining 400-plus companies, on a dollar-weighted basis, reporting a net miss. This season, a more diverse top ten only accounted for about two thirds of the net beat.

- The best news as this earnings season has unfolded is the behavior of forward earnings -- looking out a year ahead on a "blended" basis (please see the chart below). *Generally speaking, upgrades are coming in at the fastest pace in almost three years.*
- *Across size and style sectors, the upgrade rates of forward earnings have recovered from their depressed levels this March.*
- *Growth stocks -- across size sectors, and despite last month's sharp correction -- are showing the best upgrade rates of the year, indeed rates that compare with the best ever.*
- Value stocks -- across size sectors -- are showing upgrade rates lower than January's peak, but still quite robust on an absolute basis.



It remains to be seen whether this surge in forward earnings upgrades is merely a transient artifact, or whether it will endure and be a signal of a similar surge later this year in global economic activity. At the least, it is saying that on a bottoms-up basis there is no reason to see the somewhat lackluster equity returns so far this year as a sign of danger. We are going to interpret it as enhancing the value proposition for equities, and giving us reason to stand by our double-digit expectations for returns this year.

Bottom line

Clients are telling us they are disappointed and worried by lackluster US stocks returns so far in 2014. Returns are not, in fact, very far below average -- and remarkable after a 53% run in the prior 19 months from the June 2012 correction, and the ominous news backdrop. Worse returns for smaller and growthier stocks in 2014 correspond to their better returns in the prior bull run. This earnings season has been the best upside surprise in three years, with the lowering of expectations during Q1 being only a sensible seasonal adjustment. The strong net beat was distributed across the S&P 500, not concentrated as usual in just the top ten companies. Most important, the forward earnings upgrade rate is surging to its highest level in years. We stand by our expectations for double-digit returns this year for US stocks.