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MACROCOSM

The Rally in the Recession

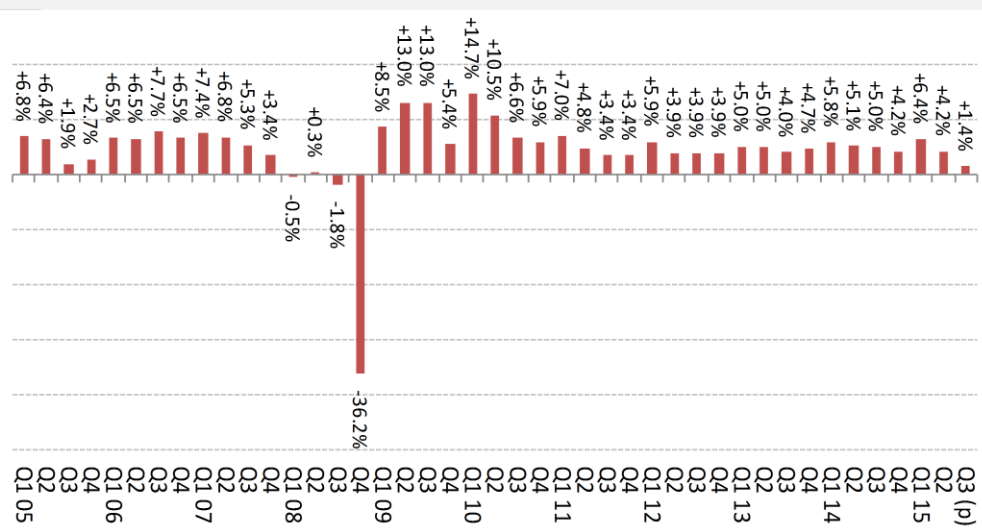
Tuesday, October 20, 2015
Donald Luskin

A disastrous earnings season, but oil has stabilized and the Fed is in revolt against Yellen.

So far this is the S&P 500's worst earnings season since Q4-2008 (please see the chart below). The dollar-weighted average surprise is an anemic beat of a mere 1.4%, compared to the average from Q1-2009 of 6.3%. Among the 59 companies reporting so far, most of the damage is coming from the big banks, several of which have gotten hit by falling bond-trading income amidst tightening credit conditions as distress in the energy sector has intensified -- with some banks "classifying" or outright charging off energy loans. *This is exactly what we warned about two weeks ago* (see "How to End a Correction with a Recession" October 9, 2015) -- *that the consensus has not adjusted its expectations for the onset of the first-ever recession caused by low oil prices.*

- It remains to be seen how earnings season will end up once another 400 companies have reported, with the big banks mostly already out of the way.
- But earnings season is about the past. What matters is the future -- and unfortunately S&P 500 forward earnings continue to languish in their rollover from highs set just over a year ago. At this point, they're 2.9% below the October 2, 2014 peak (please see the first chart on the following page).

S&P 500 earnings surprise Dollar-weighed, Q3-2015 preliminary



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS, US MACRO, US FED, OIL: This earnings season is the worst since the Great Recession, and forward earnings continue to falter globally. It is becoming increasingly clear that the global economy is slowing -- we think it's the first-ever recession caused by low oil prices. Two Fed Governors have mutinied against Yellen, calling for patience in "liftoff" -- one of them, Tarullo, has the power to squelch any lobbying from banks agitating for higher rates. With oil prices having bottomed in August, the engine of destruction responsible for this recession has shut down. Damage has been done, and will play out for months. But global stock markets can look beyond that, as they do in most recessions.

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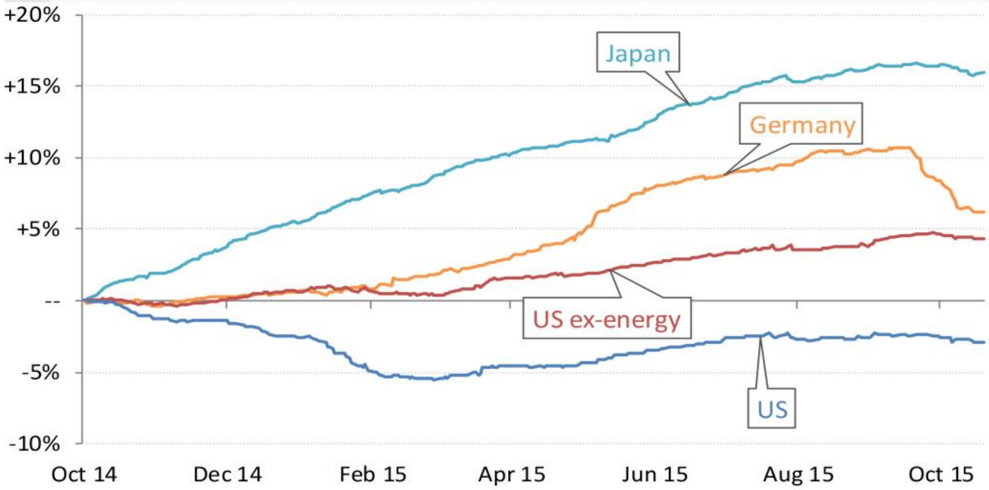
- With the energy sector removed, S&P 500 forward earnings are 4.2% *higher*. But ex-energy forward earnings seem to be rolling over now, after several on-again off-again episodes over the last year (again, please see the chart below). One culprit is Walmart -- a company not reporting in the present September-ended quarter earnings season -- whose [downward guidance last week](#) whacked almost 10% off its forward EPS. This indicates to us that distress in the energy sector is beginning to visibly radiate out to the entire economy, through the credit and CAPEX channels.
- It's a global effect. Forward earnings in Japan and Germany are well above where they were a year ago, because their stock markets do not have significant exposure to the energy sector. But over the last month or so they've begun to roll over, too (again, please see the chart below).

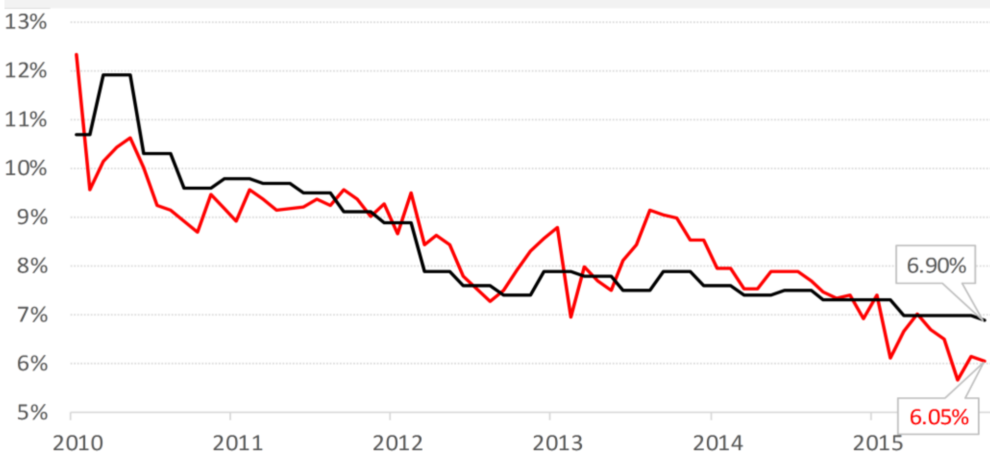
Forward earnings Change from US peak October 2, 2014



Source: Bloomberg, TrendMacro calculations

- And what report on slowing global growth would be complete without mentioning China's Q3-2015 GDP, reported at 6.9% year-over-year (please see the chart below)? The number --

China GDP growth YOY **— As reported** **— "Li Keqiang Index"**



Source: Bloomberg, TrendMacro calculations

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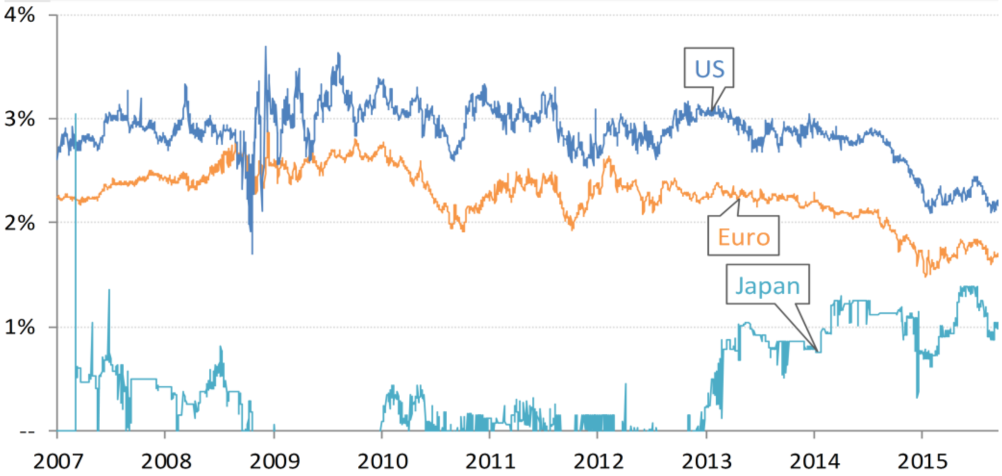
[About us]

characterized by the government as "stable" -- was artistically positioned below the idealized 7.0% mark, but above consensus expectations of 6.8%. Our version of the "Li Keqiang Index" -- a growth proxy built from electricity consumption, freight loadings and loan growth -- puts growth somewhat lower, at 6.2%, but higher than it was two months ago at the worst of the global markets' China panic (see "Another 'Reverse Oil Shock'?" July 28, 2015).

- Far-forward market-implied inflation expectations remain skeptical that central banks can or will take sufficient steps to restore price stability at their stated inflation targets (please see the chart below).

Swap implied 5-year inflation breakeven, 5 years forward



Source: Bloomberg, TrendMacro calculations

- Fed Chair Janet Yellen has significantly confused markets on this, having said plainly in the September FOMC statement and in the prepared remarks for her press conference that inflation expectations were alarmingly weak -- only to deny it in the Q&A session, and in a subsequent speech (see "'I Really Didn't Say Everything I Said'" September 24, 2015).
- Vice Chair Stanley Fischer has added to the confusion, following up a know-nothing speech on inflation at Jackson Hole (see "On Fischer at Jackson Hole" August 31, 2015) with another speech last week saying the Fed should raise rates for no better reason than "to just do it."

Which brings us to the good news, such as it is. Since all that silliness from Yellen and Fischer, two members of the Fed Board of Governors have come forward -- Lael Brainard in a speech and Daniel Tarullo in a televised interview -- worrying about signs of weakness in the economy, and urging patience on "liftoff."

- Their voices -- as Washington-based Governors, with offices down the hall from Yellen and permanent votes on the FOMC -- are far more significant than the cacophony of the usual regional Fed presidents demanding "liftoff."

- It is most unusual for Brainard or Tarullo to speak out in this way. Clearly, to us, they must think there is some urgency that demands their going public with their views. It almost has the flavor of a mutiny, of the kind we warned about when Yellen was first nominated (see "Yellen and Screamin' at the Fed" December 5, 2013).
- Tarullo's stance is especially significant, because he is the point-man on the Board for bank regulation. One of the most enduring narratives in favor of "liftoff" is that banks are demanding it. That's never made much sense to us, but if it's true, then Tarullo's opposition effectively squelches that lobbying.

But "bad news is good news" keeping the Fed on hold isn't the whole story on why stock markets around the world are behaving so well.

- *The deeper reason is that the factor that caused this recession has gotten fixed.* As with most recessions, the consequences of the damage already done have to play out over several months, but forward-looking stock markets can see beyond that -- as they have often done during recessions (again, see "How to End a Correction with a Recession").
- In this recession, we think the underlying engine of destruction has been the jointly productivity-driven and debt-driven collapse in oil prices -- long-term, a great win for the global economy, but short-term, a "disruptive technology."
- At long last the data reveals that production in the US -- now the world's swing producer -- has rolled over hard, with more to come (see "Oil's Hard Road Forward" October 5, 2015). And there's no reason at these prices to expect any significant demand-destruction, even in the face of a mild recession.
- *So we've seen the lows in global oil prices for this cycle. Which means that this recession can start the healing process before most market participants even acknowledge that there was a recession.*
- *There will be more bad news -- much of it on the credit side, as tightening financial conditions begun in the energy sector spread to other sectors. But the engine of destruction has been shut down. It won't be all one direction, but it's looking more like global stocks have seen their bottom, and will struggle higher.*

Bottom line

This earnings season is the worst since the Great Recession, and forward earnings continue to falter globally. It is becoming increasingly clear that the global economy is slowing -- we think it's the first-ever recession caused by low oil prices. Two Fed Governors have mutinied against Yellen, calling for patience in "liftoff" -- one of them, Tarullo, has the power to squelch any agitating from banks wishing for higher rates. With oil prices having bottomed in August, the engine of destruction responsible for this recession has shut down. Damage has been done, and will play out for months. But global stock markets can look beyond that, as they do in most recessions.